

January 27, 2010

DEPARTMENT OF PUBLIC SERVICE REGULATION  
BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MONTANA

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IN THE MATTER OF NorthWestern Energy's ) UTILITY DIVISION  
Application for Electric Supply Deferred Cost )  
Account Balance and Projected Electric Supply ) DOCKET NO. D2008.5.45  
Cost )

IN THE MATTER OF NorthWestern Energy's ) UTILITY DIVISION  
Application for Electric Supply Deferred Cost )  
Account Balance and Projected Electric Supply ) DOCKET NO. D2009.5.62  
Cost )

**PREHEARING FACT SHEET**

**Hearing date: February 3, 2010**

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FOR:

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**I. Introduction**

Prior to a public hearing in a docketed proceeding before the Montana Public Service Commission (PSC), Utility Division staff prepare a Fact Sheet summarizing the record, including information that may become evidence. This Fact Sheet includes background information and summaries of the procedural history and prefiled testimony in this docket. As necessary to

provide a complete description of issues and positions, the Fact Sheet also references certain data responses.

## **II. Procedural Background**

On May 30, 2008, NorthWestern Energy (NWE) filed an electric supply cost tracker filing with the PSC. NWE's tracker filing addressed the following elements: 1) the electric supply deferred cost account balance for the period ending June 30, 2008 and the projected electric load, supply and related costs for the twelve month period July 1, 2008 through June 30, 2009, and 2) a request to recover costs and related lost revenues associated with Demand Side Management (DSM) programs.

On June 27, 2008, the PSC issued Interim Order No. 6921 authorizing NWE to implement rates designed to recover an electricity supply revenue requirement of \$379,745,594. This authorized electricity supply revenue requirement reflected an net increase in electric supply rates for the 2008-09 tracker period of \$43,183,311, including the effect of an over collection of \$15,884,333 at the end of the 2007-08 tracker period. In addition, the PSC authorized NWE to continue making monthly electric rate adjustments on an interim basis.

On May 29, 2009, NWE filed another electricity supply cost tracker filing with the PSC and requested that the PSC consolidate the 2008 and 2009 filings.

On June 19, 2009, the PSC issued a Notice of Commission Action consolidating NWE's 2008 and 2009 electric supply cost tracker filings.

On June 26, 2009, the PSC issued Interim Order No. 6921a authorizing NWE to implement rates designed to recover a total electricity supply revenue requirement of \$295,080,945, which consisted of: 1) \$267,643,892 plus Colstrip Unit 4 fixed costs of \$75,832,029 plus Colstrip Unit 4 variable cost of service and design revenue of (\$26,271,515) for a total of \$317,204,406, less 2) an over collection of \$20,390,683 at the end of June 2009, over collection of Colstrip Unit 4 variable cost at the end of June 2009 of \$1,732,778, and an adjustment of \$22,123,462. In addition, the PSC authorized NWE to continue making monthly electric rate adjustments on an interim basis.

On July 9, 2009, the PSC issued Procedural Order 6921b establishing dates for intervention, discovery, testimony and additional issues procedures. Order No. 6921b established a tentative hearing date of January 13, 2010.

On November 4, 2009, NWE filed a Motion to Suspend the Procedural Schedule established by Order No. 6921b so NWE and the Montana Consumer Counsel (MCC) could pursue settlement. By Notice of Staff Action on November 6, 2009, the PSC granted NWE's motion.

On December 7, 2009, the PSC issued a Notice of Public Hearing.

On December 18, 2009, NWE filed a Motion to Establish a New Hearing Date. NWE represented that the intervenors in these dockets (MCC and Renewable Northwest Project/District XI Human Resource Council) did not object to NWE's Motion.

On December 30, 2009, the PSC issued a Notice of Commission Action establishing a February 3, 2010 hearing date.

### **III. Summary of testimony**

#### **A. NorthWestern Energy**

##### **John Hines**

John Hines, NWE's Chief Energy Supply Officer, prefiled testimony in D2008.5.45 addressing NWE's electricity supply portfolio planning and management activity during the '07-'08 tracking period. He notes that NWE prepares comprehensive, long-term portfolio management and resource procurement plans every two years. These plans, and the accompanying PSC comments on the plans, guide NWE's resource procurement and portfolio management activity. At the time Hines prefiled testimony in D2008.5.45 the PSC was reviewing NWE's 2007 plan.

Hines explains that NWE's 2005 plan focused on incremental base load resource requirements beginning in July 2007. The 2005 plan identified several methods by which NWE might procure additional resources, including auctions, bilateral negotiations, and requests for proposals. He says that the preferred resource acquisition approach from the 2005 plan involved "bridging" the time period needed to acquire long-term resources with a mix of short- and medium-term contracts.

Hines contends that NWE procured several resources consistent with the 2005 plan. In 2006, NWE conducted a pilot auction that resulted in six supply contracts ranging from nine months to 36 months, providing about 200 MW with various peak, off-peak and Sunday volumes starting July, 2007. Through bilateral negotiation, NWE and PPL Montana executed a seven-

year contract that provides NWE about 37% of its supply requirements in 2007, declining to about 23% in 2014. NWE also bid into a PPL Montana RFP to acquire 52 MW for 18 months beginning July, 2007 at a price equal to a Mid-C index less \$5.00 per MWh. NWE and its affiliate, Montana Generation, LLC, executed a contract for 90 MW from July 2007 through December 2018. And beginning in January, 2008, NWE included 21 MW from Colstrip 4 in the supply portfolio at a price equal to a Mid-C index less \$19.00 per MWh.

Looking forward, Hines describes the action items NWE identifies in its 2007 resource procurement plan. He says that in 2008 NWE will evaluate opportunities to procure mid- to long-term resources with deliveries starting in 2012 or later. NWE also plans to issue a request for proposals for community renewable resources to comply with Montana's 2010 renewable energy standards and to identify non-wind resources that would diversify the renewable portion of NWE's resource portfolio. He states that NWE will analyze utility-owned resource options in 2008 and complete a comprehensive assessment of demand-side resource potential in 2009. He notes that the 2007 plan proposes a short-term financial hedging strategy designed to increase the stability of electricity supply rates.

#### Dave Fine

Dave Fine, NWE's Director of Energy Supply Planning, prefiled testimony in D2009.5.62 addressing NWE's electricity supply portfolio planning and management activity during the '08-'09 tracking period. Fine reports that during the '08-'09 tracking period NWE: (1) rate based its 222 MW share of Colstrip Unit 4, (2) acquired a 10-year, flat, 25 MW block of power through an RFP process conducted in October, 2008, (3) acquired two 25 MW heavy load hour products through an RFP process conducted in March, 2009 (one of these products is delivered to NWE's system for the period July 2010 through June 2017, the other is delivered at Mid-C for the period July 2013 through June 2017), (4) acquired an 18-month, 25 MW product beginning July, 2009, (5) conducted an RFP for community renewable energy projects (although no resources were acquired), (6) complied with Montana's 2008 renewable energy standard, and (7) evaluated options for diversifying its renewable resource portfolio and offered contracts to several QFs.

Fine also describes the action plan items in NWE's 2007 electric supply resource procurement plan. These items include evaluating opportunities to acquire power delivered in

2012 or later, soliciting renewable resources that comply with the community renewable energy requirements of the Montana renewable energy standards, soliciting resources that would diversify NWE's renewable resource portfolio, evaluating opportunities to rate base resources, and evaluating demand side resource potential. Fine notes that, as discussed in the prior paragraph, NWE made progress on many of these action plan items during the '08-'09 tracker period. In addition, he notes that NWE will file a new electric resource procurement plan in 2009, including an updated demand side resource assessment.

Frank V. Bennett

Frank Bennett, an electric and natural gas specialist employed by NWE, addresses the status of the electric tracker. He explains that rates reflecting the 2008-09 tracker were effective on July 1, 2008 under interim Order No. 6921 in Docket D2008.5.45. Monthly rate adjustments have occurred each month beginning August 2008 through June 2009.

Bennett explains that in complying with Order 6925f, Docket D2008.6.69, NWE separated the electric supply tracker into two sections: a market-based supply cost section that reflects the same model used in prior tracker filings, and section for the rate based Colstrip Unit 4 (CU4) asset that is divided into several parts: 1) fixed cost of service, 2) variable cost of service, and 3) price stability contracts.

Bennett states that the variable cost of service for CU4 includes fuel costs and Puget Sound Energy (PSE) revenue credits, and will also include 60 percent of incremental property taxes when incurred. These variable costs are tracked in a manner similar to market based supply costs

Bennett also explains that the 12-month ended June 2009 electric supply tracker period has been updated to actual numbers from the forecasts originally filed in Docket D2008.5.45. The July 2008 beginning Deferred Account balance NWE originally filed as \$15,884,333 over collection is corrected for 12 months of actual information in Docket D2009.5.63 to \$14,223,795 over collection. Incorporating the beginning Deferred Account balance of \$14,223,795 over collection shown in Exhibit\_(FVB-2).08-09, page 2, with 10 months of actual and 2 months of estimated information, the July 2009 Deferred Account balance is a forecast \$20,390,683 over collection.

Bennett's Exhibit\_ (FVB-2).08-09 also shows updates for NWE's variable CU4 cost of service tracking items on page 6. This page shows the four months of actual information and two months of estimated information for the variable cost of CU4. The January 2009 beginning CU4 Deferred Account balance was zero and the ending balance with two months of estimated information is \$1,732,778 over collection. Combined, these two deferred accounts are \$22,123,461 over collection.

Bennett explains that the reason the over collection is so large is due to the monthly tracker setting a levelized supply rate for 12 months into the future at a time when the forward market curves were declining. This caused an over collection in the near months of the projected tracker period.

Bennett explains that there are four basic cost components that make up the Electric Supply portfolio for the 12-month tracker period July 2008 through June 2009: Electric Supply, Transmission Services, Administrative Support, and CU4. Electric Supply includes the following elements: 1) A 325 Megawatt (MW) peak and 175 MW off-peak contract with PPL Montana, LLC that is supplied seven days per week, 24 hours per day, irrespective of the operating performance of any specific electric generating facility. This contract expires on June 30, 2014. 2) Approximately 100 MW of unit contingent Qualifying Facility (QF) energy that comes from contracts entered into prior to deregulation. Only a portion of the costs of these contracts is included in the default supply portfolio. 3) Approximately 135 MW of unit contingent energy from the Judith Gap Energy, LLC wind turbine facility. This contract expires on December 31, 2026. 4) Approximately 111 MW of unit contingent energy from two prior Montana Generation, LLC contracts were assumed into the rate based CU4 asset in January 2009. 5) Approximately 50 MW of dispatchable energy from Basin Creek Equity Partners LLC. This contract will expire on July 1, 2026, unless extended for a 5-year term in accordance with the contract. 6) Approximately 6 MW of unit contingent energy that comes from Tiber Montana, LLC. This contract expires on June 1, 2024. 7) Approximately 50 MW of Sunday and North American Electric Reliability Council (NERC) Holiday firm energy from J.P. Morgan Ventures secured through the November 14, 2006 pilot auction. This contract expires June 30, 2010. 8) Approximately 25 MW of off-peak firm energy from Powerex Corp. secured through the November 14, 2006 pilot auction. This contract expires June 30, 2010. 9) Short, medium and long term market power purchases and sales with various suppliers that NWE transacts in the

market to balance variable customer demand and portfolio resources with electricity supply. The energy requirements vary in part due to customer use and seasonal weather impacts that affect demand. During the '08-'09 default supply tracking period the net non-base transaction purchase requirement was 1,878,300 MWh or 28.86 percent of the annual supply. 10) Expenses related to wind integration and other wind costs incurred to fully incorporate the wind supply contracts into the portfolio and to meet balancing authority area minimum operating reserve requirements for wind integration that are independent of the transmission and distribution system integration charges. 11) System imbalance adjustments and operating reserves. 12) DSM program implementation costs and transmission and distribution lost revenue included as expenses directly involved with DSM programs and projects.

Transmission Services are related to costs associated with moving electricity off system through point-to-point transmission service in order to balance or optimize resources, as well as other "ancillary services" required for system integrity and reliability. Regulation and Frequency Response Service, generally referred to as "load following" is an ancillary service which provides instantaneous voltage and energy regulation to balance load and resources. Costs of the transmission facilities utilized to transmit and distribute energy to default supply customers are included in delivery rates and as such, no additional revenue is collected for these costs in the tracker.

Administrative Support contains incremental administrative and general costs of \$2,477,302 (or approximately 0.81% of total default supply costs). These costs include outside legal, scheduling, software, broker costs and other incremental expenses directly related to the electric default supply (such as outside consultants to assist with or review procurement activities (RFPs)). Administrative expenses do not contain any expenses for internal Company personnel.

CU4 includes the costs and credits that were approved for inclusion under Order 6925f in Docket No. D2008.6.69. In the '09-'10 tracking year, the total fixed cost revenue requirement for CU4 is \$75,832,029 and the total variable cost of service and design revenue is (\$26,271,515).

Bennett summarizes the 12-month electric supply tracker period ending June 2010 by explaining that the June 2009 Deferred Account market based supply over-collection ending balance of \$20,390,683 is the July 2009 beginning balance. July 2009 through June 2010 information is based on forecast numbers and includes the following existing electric supply base

contracts: various qualifying facilities, Tiber Montana, Basin Creek Equity Partners, LLC, Judith Gap Energy, LLC, PPL Montana, LLC, Powerex Corp., and JP Morgan Ventures.

Together these electric supply contracts are grouped as Base Contracts in the tracker. Base Contracts are those contracts with duration of more than 18 months at inception of the contract.

Bennett explains that the total supply requirement of the 12-month period ending June 2010 compared to the 12-month period ending June 2009, estimated at 6,376,074 MWh, reflects a 2.04 percent decrease from the prior tracking period. The loads for the 12-month period ending June 2009 and June 2010 for the projected Total Sales are expected to decrease 2.12 percent or to be 127,539 MWh less in '09-'10 than in the prior tracking period. He also explains that the Non-Base transactions are projected to be 26.89 percent or 1,714,350 MWh of the total delivered supply necessary to meet load.

#### Patrick Corcoran

Patrick Corcoran, NWE's Vice President of Government and Regulatory Affairs, prefiled testimony in D2008.5.45 addressing NWE decisions related to replacing certain supply contracts with PPL Montana that expired June 30, 2007. The replacement contracts were effective on July 1, 2007, and, consequently, the question of whether the replacement costs were prudently incurred in the '07-'08 tracking period is an issue in this proceeding.

Corcoran states that in addition to the PSC's resource planning and procurement rules NWE adheres to its own internal procedures and controls to govern day-to-day energy supply planning and procurement. NWE's internal procedures vest certain individuals with authority to approve transactions, subject to risk management policies and general Energy Supply Board oversight, based on pre-assigned monetary contract amounts.

Corcoran describes the market environment at the time NWE procured supplies to replace the expiring PPL Montana contracts. He contends that transmission constraints limited out-of-state suppliers' access to Montana, that out-of-state supplies involved addition transmission costs, and that those wanting to develop new generating resources faced demands from lenders to show that project costs would be recoverable under a supply contract. Corcoran asserts that these conditions benefitted PPL Montana, and PPL Montana actively sought to protect its advantages by opposing NWE's efforts to procure power from the Basin Creek natural gas plant and the Judith Gap wind project. Corcoran contends that NWE chose to withdraw its application

for preapproval of its Montana Generation, LLC, 90 MW contract rather than disclose to PPL Montana the bids it had received in its 2004 all-source request for proposals.

Corcoran explains that through two previous, consecutive supply contracts, PPL Montana dominated NWE's supply portfolio prior to July 1, 2007. Each time those contracts expired, NWE faced an immediate need to replace a large quantity of power. Increasing market prices lead to substantial rate increases for NWE's customers when these PPL Montana contracts expired. Consequently, Corcoran contends, NWE sought to minimize rate increases and reduce its dependence on PPL Montana by diversifying its supply portfolio.

NWE issued an all-source RFP in July 2004. In late 2004 FERC initiated a review of PPL Montana's market-based rate authority. NWE, MCC and the PSC intervened in the FERC proceeding and asserted that PPL Montana exercised market power in NWE's control area. In September 2005 PPL Montana failed a FERC market power screen, establishing a rebuttable presumption of market power. However, after the parties submitted additional information FERC determined that PPL Montana had successfully rebutted the presumption of market power and granted PPL Montana market based rate authority. Corcoran states that FERC's market power proceeding influenced NWE's decision to not procure base load resources from the 2004 RFP, other than the 90 MW Montana Generation offer. Although NWE was aware of the impending expiration of its existing contracts with PPL, NWE was reluctant to arrange replacement contracts during the FERC proceeding since that might undermine the arguments of the MCC, NWE and PSC before FERC. Additionally, if FERC had determined PPL Montana had market power, one possible mitigation approach would be to require cost-based rates. Corcoran says NWE did not want to foreclose this option for ratepayers. Corcoran notes that once FERC made its final decision, NWE and PPL Montana reached agreement, in July 2006, for a seven-year contract beginning July 1, 2007.

Corcoran also states that the development of NWE's resource portfolio in this time frame was affected by uncertainty regarding NWE's future load serving obligations. He points to repeated efforts to amend the choice provisions of Montana law to create structures that would significantly reduce NWE's load serving obligations. He says that these efforts, in turn, forced NWE to assemble a portfolio of shorter-term resources in order to avoid the potential for stranded investments (he acknowledges that the portfolio requires some amount of short-term resources even absent planning uncertainty). As examples of these efforts, Corcoran points to:

(1) Montana Public Power, Inc.'s attempt in 2004 to create a public power authority from the electric customers in five cities served by NWE, representing about 65% of NWE's retail load, and (2) the City of Great Falls' efforts in 2003, 2005, and 2007 to establish itself as a municipal utility for NWE customers in Great Falls, representing about 11% of NWE's retail load.

Finally, Corcoran notes that despite the uncertainty regarding the need for base load resources to replace the expiring PPL Montana contracts, NWE proceeded to acquire the Basin Creek and Judith Gap resources.

#### Cheryl A. Hansen

Cheryl Hansen is a senior analyst in NWE's Regulatory Affairs Department. She addresses the derivation of the '09-'10 tracker period billing statistics, the derivation of deferred supply rates resulting from the over/under collection reflected in the '08-'09 tracker, and the derivation of default supply rates for the forecasted '09-'10 tracker period.

Hansen explains that cyclical usage (sales) reflects customer usage billed throughout a calendar month on each of 21 billing cycles. Each billing cycle covers approximately 30 days of metered usage. Calendar usage, on the other hand, reflects customer usage adjusted as if it were recorded for a calendar month. Bennett uses calendar data to determine energy supply costs, which are incurred on a calendar basis. NWE uses cyclical data to establish rates for billing purposes.

NWE recovers the costs associated with serving Yellowstone Park through a separately negotiated contract rate. As a result, NWE excludes Yellowstone Park's load and contract revenues from MPSC jurisdictional rate calculations.

Exhibit\_(CAH-2) 09-10 shows a remaining under recovered balance of \$2,101,615 for the '07-'08 tracking period. This amount is netted against the 12 months ended June 2009 forecasted market-based supply cost over collection of \$(22,492,299) and the proposed 12 months ended June 2009 forecasted CU4 variable cost over collection of \$(1,732,778). The total deferred supply cost account adjustment NWE proposes for amortization in this filing is an over collection of \$(22,123,461).

This filing expands the development of the electric supply rate to reflect CU4. The single electric supply rate component presented in previous filings is now replaced with three

components – a market based supply rate, a CU4 fixed cost of service rate and a CU4 variable cost of service rate.

NWE estimates total electric default supply costs of \$268,678,145. After eliminating Yellowstone Park revenues of \$1,034,254, Hansen finds that the net amount recoverable in default supply rates is \$267,643,892 for '08-'09.

The CU4 fixed cost of service is \$75,832,029. The CU4 fixed cost of service rate components presented in this filing remain unchanged and will not change until an order is issued in any subsequent CU4 revenue requirement filing.

The total revenue requirement for CU4 variable costs shown on Exhibit \_(CAH-4) 09-10, page 5 is \$(26,271,515). Two elements make up the total variable cost revenue requirement; 1) the total variable cost of \$(24,384,203), which is the sum of the forecasted fuel costs, Puget revenue credits and incremental property taxes and 2) price stability contracts in the amount of \$(1,887,312).

The separate rate components described above are combined into a single rate for customer billing as shown on Exhibit \_(CAH-4) 09-10, page 7. Both the market-based supply rates and the CU4 variable rates reflect the forecasted costs proposed in this filing, while the CU4 fixed rates remain unchanged from current.

#### William Thomas

William Thomas is NWE's Manager of Regulatory Support Services. He prefiled testimony addressing NWE's universal system benefits (USB) and electric supply energy efficiency (DSM) programs and savings. He also presents DSM program costs and estimates lost transmission and distribution revenue due to programmatic energy savings.

Total DSM savings include both USB and energy supply DSM program savings. However, since USB programs are funded by a separate charge, Thomas does not include USB expenses in his default supply DSM budget and expense figures. Table 1 shows NWE's annual DSM savings targets, reported actual savings, budgets and actual expenses for the '04-'05, through '08-'09 tracker years. Thomas explains that the reported program results represent the capability of the installed measures to produce energy savings for a full year.

**Table 1. DSM savings and expenses**

Tracking year	Target DSM savings (aMW)	Reported DSM savings (aMW)			Default Supply DSM Budget	Default Supply Actual Expenses
		USB	Default	Total		
2004-05	2.60	2.04	0.22	2.26	\$1,457,888	\$320,389
2005-06	3.70	1.33	2.08	3.41	\$2,097,734	\$1,596,076
2006-07	5.00	0.36	3.04	3.40	\$3,232,080	\$2,497,359
2007-08*	5.00	0.83	4.55	5.37	\$3,631,683	\$3,688,745
2008-09*	5.00	1.11	5.58	6.69	\$4,917,141	\$5,504,111
2009-10	5.00	-	-	-	\$6,625,192	

\* Reported savings reflect 12 months of actual savings as updated in NWE's response to data request PSC-016.

Table 2 is a portion of Thomas's Exhibit\_(WMT-1) for both the '07-'08 and '08-'09 tracker years showing expenses and reported energy savings for each electric default supply DSM program. Thomas derives reported energy savings using two approaches. First, NWE requires project-specific engineering calculations from participants in programs such as E+ Commercial Lighting and Business Partners programs. NWE's staff reviews these calculations for accuracy. Second, for programs that don't require participants to provide engineering calculations, such as residential lighting, Thomas relies on average measure savings. Reported savings represent the energy savings that would occur if all energy savings measures were in place for 12 months.

**Table 2. 2007-08 tracker period USB and default supply DSM savings**

Programs	2007-08 Default Supply DSM			2008-09 Default Supply DSM		
	Expenses	Annual Energy Savings		Expenses	Annual Energy Savings	
		kWh	aMW		kWh	aMW
General DSM expenses	427,931	-	-	182,194	-	-
E+ Business Partners/Irrigation	1,222,620	5,848,936	0.67	1,648,263	3,875,457	0.44
E+ Commercial Lighting	191,412	3,661,642	0.42	1,402,865	10,025,790	1.14
E+ Residential Lighting	1,365,146	19,943,191	2.28	1,805,540	21,996,477	2.51
NW Energy Efficiency Alliance	349,465	10,230,577	1.17	294,994	12,097,396	1.38
E+ New Homes	6,817	44,408	0.01	31,476	329,459	0.04
E+ Residential Electric Savings	54,015	111,420	0.01	123,794	272,731	0.03
E+ Electric Motor Rebate	6,915	-	-	14,985	47,806	0.01
Demand Response Program	64,434	-	-	-	-	-
<b>Totals</b>	<b>3,688,745</b>	<b>39,840,201</b>	<b>4.55</b>	<b>5,504,111</b>	<b>48,854,078</b>	<b>5.58</b>

A description of each default supply DSM program follows.

E+ Lighting: NWE contracts with KEMA to implement lighting programs for commercial and residential customers. Through KEMA, NWE offers cash rebates for ENERGY STAR CFLs and indoor and outdoor fixtures. The E+ lighting programs use several mechanisms to distribute and encourage use of ENERGY STAR CFLs and fixtures. KEMA auditors install CFLs in residential homes and commercial spaces during energy audits/appraisals. Residential customers receive a free CFL when they complete a mail-in energy audit. Residential and commercial customers can receive rebates for purchasing CFLs, ENERGY STAR fixtures, and energy efficient lighting equipment and controls. In some cases, NWE provides instant rebates through coupons. In both '07-'08 and '08-'09, NWE bought down the retail price of CFLs in all Home Depot stores in NWE's electric service area and participated in the buy down of CFLs at retailers other than Home Depot through the *Change A Light Change The World* campaign facilitated by NEEA. NWE also promotes lighting efficiency at events such as trade shows, fairs and farmers markets. Thomas states that customers continue to be highly interested in the lighting programs. In the '07-'08 tracker period 453,929 CFLs were distributed to 23,161 residential customers. Ninety one commercial lighting projects were completed. NWE provided \$741,332 toward lighting rebates in '07-'08. In the '08-'09 tracker period 297,790 CFLs were distributed to 28,497 residential customers and 500 commercial customers completed 45,715 lighting projects. NWE provided \$257,574 toward its lighting programs in '08-'09.

E+ Business Partners: NWE contracts with the National Center for Appropriate Technology (NCAT) to promote the Business Partners Program. NCAT markets the program to architect and engineering firms and trade/industry associations, contacts candidate businesses with good DSM potential, surveys and assesses buildings and facilities, provides technical assistance for building owners and assists customers with forms, contracts and other paperwork. In the '07-'08 tracker period NCAT made 437 contacts, 167 site visits and prepared 27 project proposals for customers. All 27 of these customer signed agreements to proceed with their projects. In the '08-'09 tracker period NCAT made 1,756 contacts, 475 site visits, and prepared 325 proposals for customers. Ultimately, customers submitted 22 of these proposals to NWE for approval. In addition to

NCAT's marketing, NWE DSM staff directly contacted industrial supply customers, which resulted in 2 completed projects.

Northwest Energy Efficiency Alliance (NEEA): NWE contributes to NEEA along with other regional utilities, public benefits administrators, state governments and public interest groups. NEEA is a non-profit organization that encourages market transformation – the development and adoption of energy efficient products and services – in Montana, Idaho, Oregon and Washington. NEEA's market transformation efforts target the residential, commercial, industrial and agricultural sectors. In the '07-'08 tracking period NEEA market transformation activities produced approximately 1.17 aMW of energy savings. In the '08-'09 tracker period NWE reports 1.38 aMW of savings from NEEA activities. Information on NEEA's projects can be found at [www.nwalliance.org](http://www.nwalliance.org)

E+ New Homes: In the '07-'08 tracker period NWE referred to this program as the E+ Residential New Construction Program. NWE markets this program as a combined electric and natural gas energy efficiency program. The program offers a variety of rebates for individual energy efficiency measures in new homes. KEMA now administers the rebate portion of the program and also collects data and maintains program records. NWE contracts with NCAT to provide builder/owner education, technical assistance, marketing, and outreach. NWE blends USB and supply funds to promote ENERGY STAR Homes Northwest residential building standards. NWE uses USB funds to market the program and educate architects, contractors, and customers. NWE uses electric supply funds to provide cash incentives. Thomas states that, separately, NEEA funds some of the infrastructure development of ENERGY STAR Northwest activities. In the '07-'08 tracker period two new electrically heated homes were certified and five new gas-heat homes installed at least 50% ENERGY STAR lighting through this program. In the '08-'09 tracker period four new electrically heated homes were certified and five new natural gas heated homes installed at least 50% ENERGY STAR lighting.

E+ Residential Savings Program: NWE introduced the E+ Residential Savings program in April, 2006. This program provides incentives for customers to install insulation, switch electric space or water heat to natural gas and install energy saving devices like programmable thermostats,

low-flow showerheads, faucet aerators and water heater pipe insulation in existing homes. NWE contracts with KEMA to implement the program. NWE's website provides information, program guidelines and rebate forms. Thirty three customers participated in this program in the '07-'08 tracker period.

E+ Electric Motor Rebate Program: NWE contracts with KEMA to implement the program, which offers cash rebates for purchasing premium efficiency electric motors. Prescriptive rebates are offered for motors rated between 1 and 200 horsepower. Larger motors can qualify with individual, application-specific calculations performed by NWE. In the '07-'08 tracker period one rebate application was processed. Thomas states that NWE modified the program to include motor rewinding. Motor rewinding that adheres to NEEA-developed procedures designed to avoid efficiency losses will qualify for rebates from NWE. Thomas says three electric motor service centers in NWE's service territory perform this service. Despite the program modification, only one motor rebate application was processed in the '08-'09 tracker period. Thomas reports that NWE is considering eliminating this program from its DSM portfolio. He says in the '09-'10 tracking period NWE will offer rebates directly to motor dealers who agree to stock premium efficiency motors instead of standard motors. After evaluating the results of this change, NWE will determine whether to continue the program beyond the '09-'10 period.

#### Green Blocks Pilot Program

In 2008, NWE partnered with the City of Missoula on a pilot residential DSM program that combined elements of the E+ Audit, Lighting and Residential Savings programs. Through this pilot program NWE sought to provide energy audits and some energy efficiency measures free of charge to targeted and concentrated groups of program participants in order to achieve cost-effective electric and natural gas savings. The City of Missoula provided marketing, outreach, recruiting and selection of up to 100 program participants. NWE provided the home energy audits and installed cost-effective DSM measures at no direct cost to participants. Ultimately, the pilot program served 93 households at a total cost of \$146,117 and produced 50,250 kWh per year of electric energy savings. NWE's economic analysis of the pilot program shows a total resource cost (TRC) test value of 0.86, which NWE considers marginally cost-effective.

Thomas also describes a multitude of training seminars that NWE's DSM staff and contractors sponsor throughout the year to increase awareness of energy efficiency opportunities in buildings and facilities. NWE blends USB and supply funds to cover the cost of these seminars. Topics the seminars address include: efficient motor management, compressed air, pumping, building operator certification, lighting design lab, ENERGY STAR Northwest verifier training, and ENERGY STAR builder training. Additionally, Thomas says NWE promotes energy efficiency throughout its service territory through media events, appearances, meetings, speaking engagements, booth sponsorships, trade fairs and shows, conferences and other special events. He contends that NWE maintains networks of retailers, distributors, and other trade allies and provides a steady stream of information about its energy efficiency programs through print, radio, television, literature, and personal contact. He includes, as Exhibit\_(WMT-5a) to his testimony, NWE's 2009 USB/DSM Communications Plan. The Communications Plan details the techniques, mechanisms, locations, forms of media and calendar schedule of activities designed to support DSM programs, attract customer participation, and acquire cost-effective DSM resources. He notes that the Plan will change over time as conditions warrant or new knowledge is gained.

In D2009.5.62 Thomas notes that the American Recovery and Reinvestment Act of 2009 (ARRA) may provide funds to Montana state and local governments through the State Energy Program and Energy Efficiency Block Grants Program. He says NWE is discussing with Montana's Department of Environmental Quality and other units of the state and local government ways to blend and leverage NWE's DSM program funding with ARRA and other funding sources to increase service offerings, participation and, ultimately, the amount cost-effective DSM resources acquired.

Also in D2009.5.62 Thomas reports that NWE hired NEXANT, Inc., with The CADMUS Group, Inc. as subcontractor, to perform a comprehensive assessment of DSM potential on NWE's system. He expects preliminary findings and conclusions in September, and final results by the end of 2009.

Kevin Markovich

Kevin Markovich is NWE's Director of Energy Supply Market Operations. In Docket D2008.5.45, Markovich describes NWE's electric supply hedging strategy included as Appendix 1 to the 2007 electricity supply resource procurement plan (see Docket No. N2007.11.138). In Docket D2009.5.62, he addresses the operation and management of the rate-based Colstrip Unit 4 asset, discusses changes to NWE's real-time scheduling activity, and asks for PSC approval to engage in financial swaps as part of the electricity supply hedging strategy.

Markovich explains that NWE's hedging strategy is intended to dampen volatility, enhance price stability and provide a framework against which to evaluate the prudence of the Company's resource procurement activities. He notes that the hedging strategy will not produce either the lowest or highest possible electricity supply prices, but will reflect market conditions over time rather than at any particular moment.

Markovich describes the hedging strategy as both structured and flexible. It is structured because it calls for acquiring fixed-price supplies according to specific timelines; as NWE gets closer in time to a load serving obligation, more of the supply portfolio becomes fixed in terms of price (e.g., more supply will be at fixed prices for next month's expected load than for next quarter's expected load). He says the strategy is flexible because the target fixed-price quantities are ranges rather than hard targets so the Company can consider prevailing market conditions. He says systematic purchases according to the hedging strategy can avoid large cliffs of volumetric exposure (i.e., needing to procure a large quantity in a short-period of time) and reduce the amount of supply procured the hourly spot market. He emphasizes, however, that the hedging strategy cannot insulate customers from market price trends.

In D2009.5.62 Markovich recounts how, in Docket N2007.11.138, NWE asked the PSC to comment on the reasonableness of using financial swaps as part of its hedging strategy. The PSC's comments note that none of the parties to Docket N2007.11.138 commented on NWE's hedging strategy or the use of financial swaps. Because Docket N2007.11.138 was not a contested case, the PSC advised NWE to highlight the use of financial swaps in its next annual electricity supply cost tracking docket, where the PSC evaluates the prudence of supply costs. Consequently, Markovich notes, NWE has not used financial swaps in its electricity supply hedging activities.

Markovich contends that NWE has used financial swaps as part of its natural gas supply activities and that they have reduced the impacts of market price volatility on retail natural gas rates. He also asserts that natural gas financial swaps have reduced administrative tasks and helped NWE manage credit issues more efficiently. He explains that a financial swap is a transaction between two parties in which one pricing point is traded or swapped for another; usually an index price is swapped for a fixed price in what is called a “fixed for float swap.” He says financial swaps are paper transactions because no physical exchange of natural gas or electricity occurs. Instead, the difference between the two pricing points results in one party paying the other. He offers the following example: In November 2010 NWE wants to lock in the price of 50 MW of electricity for 2011 (i.e., 438,000 MWh). The forward price for 2011 at the time is \$60/MWh. Through a financial swap NWE would trade the actual market price in 2011 for the fixed \$60/MWh price. If, at the end of 2011 the actual market price in 2011 was \$70/MWh, NWE’s counterparty would have to pay NWE \$4.38 million (438,000 MWh x (\$70 - \$60)). In 2011, NWE would have paid a physical supplier \$70/MWh for 438,000 MWh, or \$30.66 million, but the \$4.38 million payment associated with the financial swap brings the net cost to NWE to \$26.28 million, or \$60/MWh. Conversely, if the actual market price in 2011 had been \$50/MWh, NWE would have had to pay its counterparty, effectively raising the cost of the 438,000 MWh to \$60/MWh. Markovich states that the credit available to each party is an important consideration in a financial swap because each party marks the transaction to market to determine their financial exposure.

Regarding Colstrip Unit 4, Markovich states that NWE has not experienced any problems scheduling and tagging energy from this recently rate-based resource and that communication protocols for plant output and operating conditions are in place and working well. He describes the reciprocal sharing agreement with PPL Montana that allows NWE and PPL to operate and receive output from Colstrip Units 3 and 4 as if each company owned 15% of each of the units. He says the reciprocal sharing agreement benefits both companies by diversifying operational and catastrophic risk across two units instead of one. He reports that occasionally market prices for power have fallen below the variable cost of operating the plant and that if NWE’s schedulers judged that such market conditions would persist long enough they reduced the plant’s output. He also notes that NWE sells a portion of the output from Colstrip Unit 4 to Puget Sound Energy through an agreement that ends December 29, 2010.

In March 2009 Colstrip Unit 4 shut down for scheduled maintenance. Markovich reports that maintenance personnel found a small crack on one of the steeples holding the blades of the turbine. After further analysis the plant's owners decided to repair both low pressure turbine rotors, which has resulted in a prolonged outage (see data response MCC-035). Due to the reciprocal sharing agreement NWE's generation loss is half of what it would have been without the agreement.

In D2009.5.62, Markovich reports on changes to NWE's real-time scheduling activity. He explains that from 2002 through 2008 NWE outsourced this activity. In 2008, during contract renegotiations with its real-time scheduling agent, The Energy Authority (TEA), NWE asked to increase the termination notice in the contract from 60 days to six months because it felt it would be nearly impossible to find another provider or internalize the activity within the 60 days. TEA was not willing to make the change, so NWE solicited proposals from other potential providers. NWE selected Highland Energy, a Butte, Montana-based company to take over the real-time scheduling function. Markovich says having NWE's real-time scheduler so close proved valuable because training and communication were more efficient and meetings were easier to schedule because there were no time zone differences. However, Highland Energy notified NWE in November, 2008, that it was going out of business. NWE then decided to bring the real-time scheduling function in-house by acquiring experienced Highland Energy employees who would soon be unemployed. Markovich reports that NWE purchased, for a nominal fee, miscellaneous office equipment and the right to recruit Highland Employees in return for waiving a six month notice requirement in the Highland-NWE service contract. NWE interviewed numerous Highland employees and eventually made employment offers to five. On December 28, 2008, the real-time scheduling function was brought in-house. Markovich notes that since 2002 contract expenses for real-time scheduling services have been recovered through the electricity supply tracker, but that NWE has never included any internal labor costs in the tracker. He asserts that labor costs associated with the real-time scheduling function are directly attributable to energy supply so it is appropriate to include them in the energy supply tracker.

Markovich contends that NWE prudently supplied electricity during the 2007-08 and 2008-09 tracking periods. He notes that the Company never interrupted or restricted service because of actions or inactions of its energy supply function and it was not fined or penalized by any oversight authorities for its resource scheduling and operating performance.

B. Montana Consumer Counsel

John W. Wilson

Dr. John W. Wilson presents testimony on behalf of MCC pertaining to NWE's proposed cost recovery in Electric Supply Tracker filings for the periods July 1, 2007 through June 30, 2008 and July 1, 2008 through June 30, 2009, and for the forecasted period July 1, 2009 through June 30, 2010. Wilson finds that the Electric Supply cost recovery proposed by NWE for the 12-month tracking period ended June 2008 is reasonable and should be approved by the Commission.

Wilson observes that, on an overall basis, the electric supply costs reported by NWE for the three tracker periods are nearly the same. NWE's average electric supply cost in the '07-'08 tracker year was \$47.15/Mwh. In the '08-'09 tracker year the average cost increased slightly to \$48.55/Mwh, and the estimated '09-'10 tracker year costs return to \$47.06 – nearly the same average cost as in the '07-'08 tracker year.

Wilson states that while the overall cost of electric supply has remained about the same over the three tracker years, the costs of some components have changed. For example, the cost of market transactions, which account for 27% to 29% of supply in each tracker year, declined significantly from nearly \$60/Mwh in the first two years to just over \$40/Mwh in the estimated '09-'10 tracker year. In contrast to this market cost decline, NWE's costs of other supply components had offsetting increases so that the overall average supply cost remained relatively stable.

NWE estimates that it lost \$164,523 of Commission-authorized CU4 revenue in the '08-'09 tracker year due to successful electricity conservation/energy efficiency programs, and that it will lose another \$577,988 in the '09-'10 tracker year. However, according to Wilson, NWE does not find that without a DSM-related CU4 lost revenue adjustment CU4 revenues will be less than CU4 costs. Wilson contends that NWE divided its CU4 fixed cost of service revenue requirement (\$75,832,029 - determined in Order 6925f, Docket No. D2008.6.69) by 2007 test year kWh sales to set the rate assessed to each customer. Because 2007 test year kWh sales were less than actual kWh sales in tracker year '08-'09 and less than estimated kWh sales in tracker year '09-'10, CU4 fixed cost revenues in each of these tracker years exceed the PSC-determined annual CU4 fixed cost of service.

NWE asserts that without DSM, kWh sales would have been larger than they were, resulting in larger CU4 fixed cost revenues. Wilson observes that NWE is asking the PSC to add back this lost revenue as additional tracker revenue, even though it is in excess of the PSC-determined CU4 fixed cost of service, so that NWE will not lose its enthusiasm for DSM.

Wilson asserts that actual CU4 supply has not exceeded the amount that was expected in Docket D2008.6.69. Beginning in April 2009 and continuing through the present (i.e., the date of Wilson's testimony), CU4 experienced a lengthy, unexpected outage, and generation supply from the plant has been, and is now expected to be, significantly lower in the '08-'09 and '09-'10 tracker years. Wilson finds that the reduction in CU4 production is attributable to this outage, not to DSM. The lost sales that NWE attributes to DSM are from all sources of supply, including replacement market purchases that consumers are funding to make up for the CU4 outage, as well as incremental supplies to serve post-2007 test year sales growth. According to Wilson, since NWE recovers its CU4 fixed costs of service from a surcharge on all sales, and since DSM reduced these total kWh sales from what they might have been without DSM, NWE is requesting a tracker adjustment for additional CU4 revenue, even though total kWh sales have increased from the 2007 test year amount and NWE is, therefore, already recovering more than the \$75,832,029 CU4 fixed cost of service approved by the PSC in Docket D2008.6.69.

Until the end of 2008 NWE contracted with outside consultants to perform the real time scheduling for its power supply requirements. The costs of these consulting services were included as administrative expenses in NWE's tracker filings through 2008. At the end of 2008, NWE began performing the required real time scheduling for its system with its own employees. NWE is now proposing to include its allocated internal labor and administration costs of real time scheduling as tracker costs.

Wilson believes this would be a significant change. NWE has never before recovered any of its own internal labor or administrative costs associated with energy supply through its tracker filings. He states that NWE previously proposed to recover such internal labor and overhead costs associated with energy supply through its tracker filings in Docket No. D2005.5.88 (NWE proposed to include staff labor costs associated with new DSM program employees in its electric tracker). Wilson says that in that case he testified that such intermittent increments to staff positions between rate cases are inappropriate for tracker rate adjustments since they single out one test year cost component that has increased, while ignoring offsetting

changes, such as labor productivity gains or other employee reductions that cause costs to fall. Wilson contends that it is inconsistent with long established test year ratemaking principles, and is one-sided and unfair to consumers, to increase rates between rate cases to account for employee additions but to make no corresponding adjustments for employee eliminations or productivity gains. He says this approach would undermine the essential balancing feature of comprehensive rate cases and impose an uneven ratemaking mechanism between rate cases that surcharges consumers for interim changes that cause costs to rise but fails to credit them for changes that cause costs to fall.

Wilson finds that the PSC agreed with his arguments in Docket No. D2005.5.88. In Final Order No. 6682d, the PSC held:

“MCC argued that it is inconsistent with long established test year ratemaking principles to attempt to increase rates between rate cases to account for employee additions but to make no corresponding adjustments for employee reductions. NWE stated that the position would be solely dedicated to the acquisition of DSM resources for the default supply portfolio. Labor costs for other employees involved in acquiring default supply resources are not included in electricity supply costs. The Commission finds that the labor charges associated with the DSM Program Coordinator should not be recovered through the electric tracker. Rather those costs should be considered in a general rate case. NWE’s request to include labor expense of \$52,070 for the position of DSM is not approved for inclusion in the electric tracker. NWE is free to file for approval of the labor expense associated with the DSM Program Coordinator in its next general rate case.” He believes the Commission should continue to uphold these same regulatory principles in this case.”

With regard to NWE’s request for approval to use financial swaps (“fixed-for-float”) to procure electric supplies, Wilson says these financial swaps are financial derivative transactions. In such transactions, NWE agrees to pay another party a negotiated fixed price associated with a specified quantity of electricity in a specified future time period. At the same time, the other party agrees to pay NWE the actual market price in that future time period for the same specified quantity of electricity. These purely financial transactions would not involve any physical sales of electricity. Thus, if the negotiated price is \$50/Mwh and the market price in the future period turns out to be \$30/Mwh, NWE would pay the other party the net amount of \$20 for each Mwh of the specified contract quantity. In that case, whereas NWE would be able to buy actual physical quantities of electricity for \$30/Mwh, the effective cost, including the swap payment of \$20/Mwh, would increase the total price to \$50/Mwh. Conversely, if the negotiated price is \$50/Mwh and the market price in the future period turns out to be \$70/Mwh; NWE would collect

the \$20 net amount from the other party for each Mwh of the specified contract quantity. In that case, NWE would use the \$20/Mwh that it collects from the other party to offset the \$70 market price that it actually pays for physical quantities of electricity so as to reduce the effective cost from \$70 to \$50. In this illustration, the effective cost of electricity is \$50/Mwh in both cases even though the actual market cost ranged from \$30/Mwh to \$70/Mwh. Wilson notes that it is unlikely in the real world that winning and losing swaps will exactly offset each other, and that the counter parties who would do the swaps with NWE are highly sophisticated and practiced trading experts who are not in business to break even.

Wilson states that NWE has established a track record using financial swaps in conjunction with its natural gas supply activities. Mr. Markovich testifies in this case that NWE uses financial swaps in its Montana natural gas supply function and that they have worked exactly as expected in that they have reduced the impacts of market price volatility on the Company's natural gas supply rates.

Wilson questions whether financial swaps have worked well for the company with regard to gas supply. He says that if "working well" means reducing the impact of price volatility, one may be able to reach that conclusion. However, if "working well" means reducing costs for consumers, things have not worked out that way. As shown in response to data request MCC-037(a), NWE's natural gas fixed-for-float transactions resulted in net payments by NorthWestern to counter parties of \$11.0 million from November, 2007 through June, 2009, increasing the cost of the gas covered by these swaps by \$3.07/MMBtu or 55.7%. In view of NWE's track record on the gas side, Wilson says the PSC may think better than to give NWE the requested authority to engage in financial swaps in procuring electricity supplies. To the extent that further hedging is deemed desirable, future consideration might be given to the use of electricity call options, which would provide protection against extreme upside price movements at a known and limited cost and far less risk of the very large above market cost results that NWE has encountered in its fixed-for-float gas price transactions.

#### **IV. Summary of Stipulation**

According to the stipulation, the parties disagreed on three discrete issues in these dockets: 1) whether NWE should be allowed to recover through the tracker certain labor costs associated with employees that perform real-time scheduling functions, 2) whether NWE should

be allowed to employ financial swaps, and 3) whether NWE should be allowed to recover claimed lost Colstrip Unit 4 fixed cost revenues due to DSM activities.

NWE included labor costs related to in-house real-time scheduling employees in its electricity supply cost calculations. MCC contends that internal labor costs have not and should not be included in trackers, but, instead, should be considered in general rate case filings. Prior to bringing the real-time scheduling function in-house, NWE included in the tracker contract costs paid to third parties that performed scheduling services. The stipulation provides that NWE should collect revised labor costs of \$27,000 per month through the tracker for internal scheduling labor costs from January 1, 2009, until the date on which rates are effective following a final order in NWE's next general rate case. Upon issuance of a PSC final order, NWE will remove labor costs for real-time scheduling from the tracker.

The stipulation provides that NWE will withdraw from these dockets its request to use financial swaps in its electricity supply operations. NWE agrees to provide additional information and discuss the issue of financial swaps with MCC. The stipulation provides that if NWE seeks PSC approval to use financial swaps in the future, MCC will provide testimony describing its position.

NWE calculated lost Colstrip Unit 4 fixed cost revenues related to DSM activity during the '08-'09 tracker period (i.e., July 1, 2008 through June 30, 2009) of \$166,041. MCC disputed NWE's lost revenue claims. The stipulation provides that NWE should collect one half of NWE's calculated lost revenues, \$83,021. The parties agree that NWE should make this adjustment to the lost revenues included in the actual '08-'09 tracker activities and, therefore, in the deferred balance associated with the '08-'09 tracker period to be reflected in the '09-'10 tracker period electric supply deferred charge.

The parties stipulate that all other aspects of NWE's 2008 and 2009 tracker filings are reasonable and should be approved by the PSC. A copy of the stipulation is attached to this fact sheet.