PUBLIC SERVICE COMMISSION
STATE OF MONTANA

Memorandum

To: Commissioners, Kate, Mike, Eric & Al

From: Scott Fabel and Will Rosquist

Date: April 20, 2010

Re: Staff recommendation regarding NWE-MCC stipulation in Dockets D2009.5.62 & D2008.5.45 - NWE electric trackers

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Procedural Background

On May 30, 2008, NorthWestern Energy (NWE) filed an electric supply cost tracker filing with the Montana Public Service Commission (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 a 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 2, 2009, NWE and MCC filed a Stipulation.

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.

On February 3, 2010 the hearing was held.

Staff analysis

Labor costs for in-house, real-time scheduling employees

The stipulation explains that NWE has historically included in the supply tracker costs for real-time scheduling performed by outside consultants. Mr. Markovich explains in pre-filed testimony that NWE decided to bring the real-time scheduling function in-house at the end of 2008. He contends that real-time scheduling labor costs are directly attributable to energy supply and, therefore, it is appropriate to include them in the supply tracker.

The stipulation notes that MCC does not believe NWE's internal labor costs should be included in trackers, but in general rate cases. Observing that real-time scheduling costs associated with consultants were included in the tracker before NWE brought that function in-house, the stipulation allows NWE to collect $27,000 per month for internal real-time scheduling employee costs from January 1, 2009 until the date on which rates are effective pursuant to a PSC final order in NWE's next general rate case. On that date, NWE will remove real-time scheduling labor costs from its supply tracker. Mr. Bennett's tracker spreadsheet included approximately $40,000 per month for in-house real-time labor costs. The stipulation specifies that the real-time labor cost adjustment related to the period January 2009 through June 2009 will be included in the actual '08-'09 tracker activity and, therefore, in the '09-'10 deferred balance associated with the '08-'09 tracker period and reflected in the '09-'10 deferred charge.

At the hearing, NWE's witness Patrick Corcoran acknowledged that the PSC might approve an interim revenue requirement in NWE's pending rate case that would reflect NWE's in-house real-time scheduling labor costs and, in that event, NWE would collect those labor costs both in electric supply rates and in interim transmission and distribution rates. Mr. Corcoran testified that if the PSC approves the stipulation, but modifies it so real-time labor costs must be removed from the supply tracker when rates implementing an interim order in NWE's rate case take effect, NWE would not consider the PSC's action a rejection of the stipulation. Tr. pp 30-31. In addition, NWE's witness John Hines and MCC's witness Dr. Wilson testified at the hearing that the reference in the stipulation to NWE's "next general rate case" means PSC Docket No. D2009.9.129. Tr. pp 14, 103.

The NWE-MCC dispute over real-time labor costs is related to Montana's electric industry restructuring activity. Traditionally, utility labor costs were not candidates for cost tracking and rate adjustment mechanisms. NWE's electricity supply cost tracking and rate adjustment mechanism arose from its obligation, during the restructuring era, to be the default supplier (or supplier of last resort) for customers that were not buying their electricity supply from unregulated, competitive suppliers. Initially, Montana law envisioned that NWE's default supplier obligation would be temporary, while customers transitioned from utility-supplied service to market-supplied service. Montana law required NWE to separate its distribution- and transmission-related costs and prices from its supply-related costs and prices so customers could easily compare default supply service to competitive offers. Over time, NWE's default supplier role became more permanent and since 2009, NWE again has a traditional utility supply obligation. However, NWE still wants to maintain the functional separation of distribution, transmission, and supply costs and rates. (See D2009.9.129)

Until recently, the electricity supply tracker was the only mechanism through which NWE recovered supply-related costs. However, Montana law now allows NWE to own and rate-base electricity generating assets that have traditional revenue requirement elements that are not subject to adjustment in the supply tracker. CU4 is an example. At the hearing, Wilson urged the PSC to move toward comprehensive revenue requirement proceedings that include supply assets, like CU4, as well as other non-tracker revenue requirement issues, like labor costs. Tr. p. 106.

NWE's rate structure will evolve as the Company transitions back from its role as a default supplier to its role as a more traditional utility. The stipulation provides a reasonable resolution of the real-time in-house labor cost issue, given the state of this evolution. The PSC should approve this element of the stipulation, modified to require removal of these costs upon issuance of an interim order in D2009.9.129.

DSM-related Colstrip Unit 4 lost revenues

The stipulation explains that NWE calculated DSM-related Colstrip Unit 4 lost revenues of $164,041 for the July, 2008 through June, 2009 tracker period, that MCC disputes NWE's lost revenue claims, and that the parties agree that NWE will collect one half of its calculated amount, or $83,021.

In his pre-filed testimony, Dr. Wilson recounts how the per kWh charge that recovers NWE's Colstrip Unit 4 fixed cost of service was set by dividing the roughly $75.8 million fixed cost of service revenue requirement by 2007 test year kWh sales. Because 2007 test year sales were less than actual sales in the '08-'09 tracker period, and less than expected sales in the '09-'10 tracker period, Wilson says actual CU4 fixed cost revenue in each of these tracker periods exceeded or is expected to exceed $75.8 million. In light of this, he questions whether additional Colstrip Unit 4 revenue (in the form of lost revenue recovery) is necessary. He also points out that due to an unexpected, lengthy outage that began in April 2009, energy production from the plant was lower in the '08-'09 and '09-'10 tracker periods than NWE projected in the Colstrip Unit 4 pre-approval docket. He questions whether a lost revenue adjustment is appropriate, given this outage.

In Order 6574e the PSC approved a mechanism that allows NWE to recover DSM-related lost transmission and distribution revenue. That Order reads, in part,:

> "…the Commission finds that the lost revenue disincentive is real and puts at risk a full and complete ramp-up of cost-effective energy efficiency resource acquisition programs in the near-term. Strong NWE support for energy efficiency and other demand-side resources (e.g., rate design, demand response) is particularly important today given the recently demonstrated volatility of energy supplies and wholesale prices. … In light of the widely acknowledged disincentive tied to lost T&D revenue, the public interest value of DSM, and incomplete information on the existence and effectiveness of countervailing incentives, the Commission is not willing to risk creating lost opportunities with regard to NWE's acquisition of cost-effective efficiency resources." Order 6574e, ¶ 156.

When NWE acquires DSM, its Colstrip Unit 4 fixed cost recovery is affected in the same way as its transmission and distribution fixed cost recovery. NWE currently relies on per kWh charges to recover all of its Colstrip Unit 4 fixed cost of service revenue requirement, and most of its transmission and distribution revenue requirement, between rate cases. To the extent effective DSM programs reduce kWh sales between rate cases from what they would have been without those programs, NWE's fixed cost of service revenue is also reduced from what it would otherwise have been. Whether or not actual Colstrip Unit 4 fixed cost revenue exceeds the PSC-determined revenue requirement is irrelevant to the question of whether NWE faces a financial disincentive to acquire DSM due to lost revenue. The financial disincentive hinges on whether NWE's revenue would be higher but for acquiring DSM, not on any absolute revenue amount. Similarly, the amount of energy Colstrip Unit 4 produces is irrelevant to whether NWE faces a financial disincentive to acquire DSM because customer use drives Colstrip Unit 4 fixed cost recovery between rate cases, not the plant's output.

The PSC has authorized NWE to recover DSM-related lost transmission and distribution fixed cost revenue. Conceptually, DSM-related lost Colstrip Unit 4 fixed cost revenue and DSM-related lost transmission and distribution fixed cost revenue produce the same financial disincentive to acquire DSM. The stipulation represents a compromise between NWE and MCC designed to resolve contested issues in this proceeding. This compromise allows NWE to recover a portion of its calculated DSM-related lost fixed cost revenue for Colstrip Unit 4. For these reasons, and based on the evidence before the PSC in this case, staff considers the stipulation's resolution of the Colstrip Unit 4 lost revenue issue reasonable.

2004 RFP

In January, 2004, NWE filed its first electricity supply resource procurement plan in compliance with the PSC's Default Electric Supplier Procurement Guidelines, ARM 38.5.8201-8226. The plan indicated that NWE should procure additional baseload, wind and dispatchable resources to achieve the lowest cost, lowest risk supply portfolio. Following the plan, NWE issued an all-source request for proposals (RFP) in July, 2004, to identify and acquire specific resources consistent its plan. NWE hired Lands Energy Consulting to administer the RFP and perform an initial economic analysis of the offers. NWE received 35 long-term offers, representing 63 different potential transactions (some offers consisted of multiple possible transactions). Lands Energy categorized the possible transactions as: 1) wind, 2) baseload and standard shaped, 3) dispatchable, 4) dispatchable coal, and 5) other. The other category included a "slice" product and a partial requirements product offered by PPL Montana (PPL). (A slice product generally involves supplying a percentage of the load serving requirement. A partial requirements product generally provides all energy needed to serve loads after accounting for other supplies.) Lands Energy recommended eliminating 10 possible transactions from further analysis because they either failed to conform to the RFP or were obviously not competitive.

Lands Energy performed an initial economic screening of the possible transactions using a spreadsheet model that compared, on a net present value basis, the annual cost per MWh of a transaction to the forecast of market prices used by the Northwest Power and Conservation Council in its 5th Regional Power Plan. Based on this analysis, Lands Energy assigned each transaction to one of three Tiers: Tier 1 transactions were considered worthy of additional analysis using NWE's comprehensive resource planning model, GenTrader; Tier 2 transactions were considered potentially worthy of additional analysis depending on how Tier 1 transactions faired in GenTrader modeling; and Tier 3 bids were considered non-competitive. Lands Energy assigned twelve of PPL's offered transactions to Tier 1, although Lands Energy did not reveal PPL's identity to NWE at this stage of the economic evaluation process. Five of the Tier 1 PPL offers were in the baseload/standard shaped category, three were in the dispatchable category, one was in the dispatchable coal category, and three were in the other category.

NWE conducted more comprehensive modeling of the Tier 1 offers using its portfolio cost model, GenTrader. Using GenTrader, NWE combined customer load profiles, supply profiles for existing resources, such as qualifying facilities and then-existing PPL contracts, and long-term wholesale electricity price forecasts along with various combinations of Tier 1 offers to model total supply portfolio cost and risk (the risk measure was a function of a portfolio's exposure to wholesale market price volatility). In December, 2004, Mr. Corcoran and staff from NWE's energy supply function met with the Company's internal Energy Supply Board to discuss the RFP analyses and recommend a course of action. The energy supply staff recommended pursuing an electricity supply portfolio that included a "slice" contract with PPL which would fill about 42%-50% of un-contracted supply obligations, contingent on NWE's ability to negotiate a favorable price for such a product. The energy supply staff reported that, at that time, PPL and NWE were $40 million apart from a deal that the energy supply staff considered reasonable, given existing and projected market conditions. According to Lands Energy's economic analysis of RFP offers, in November, 2004, PPL's offered price for a 40%-50% slice product stood at about $45.00/MWh. In a December 23, 2004, letter to PPL, NWE made a counter-offer that included an average price of $36.50 per megawatt-hour, which PPL rejected on December 29, 2004. In its letter to NWE rejecting the counter-offer PPL stated that it viewed NWE's counter-offer as a rejection of PPL's initial offer. DR PSC-022(b), Attachment 1, p. 3.

At the public hearing in this proceeding (D2008.5.45/D2009.5.62) Commissioner Molnar asked Mr. Corcoran why NWE rejected PPL's offer for a full-services contract at an all-in price of $37.40/MWh. Tr. p 54. Record evidence indicates that this $37.40/MWh price was actually associated with the slice product and covered the period January 1, 2005 through June 30, 2007. Also, as Commissioner Molnar noted, PPL later increased this price, to $38.45/MWh. At the time, NWE already had two contracts with PPL that would provide supplies through June 30, 2007. Thus, Mr. Corcoran explained that accepting PPL's offer would mean replacing 300 MW of firm power and 150 MW of unit contingent on-peak power at an average price of $32.00 for the new offer at $38.45, an additional cost of $130 million over the January 1, 2005 through June 30, 2007 period. Tr. p. 59. PPL's full requirements offer price for the period July 1, 2007 through June 30, 2008 was $39.20/MWh and rose to $42.20/MWh for the 2013-2014 period. DR PSC-022(d), Attachment 1, p. 335.

Lands Energy, in analyzing PPL's requirements offer, determined that the offer was not, in fact, a true requirements product and that it contained a number of limitations and restrictions that could potentially increase the offer price significantly. DR PSC-022(d), Attachment 1, p. 317. For example, PPL was only required to deliver supply at the offered price if NWE's load was between

300 MW and 1,000 MW.[1/] If NWE's load was greater than 1,000 MW, PPL would supply that load at 120% of market price, and for NWE loads that exceeded 1,250 MW, PPL would have no supply obligation. Lands Energy also noted that PPL's offer excluded all volumetric risks associated with NWE's qualifying facility contracts; to the extent power deliveries from qualifying facilities were less than a predetermined amount, PPL Montana would supply the difference at 120% of the market price. PPL's offer also excluded responsibility for intra-hour changes in NWE's load (i.e., load following). For comparison, Lands Energy reported that another bidder offered a true requirements proposal at a fixed price of $52.50/MWh.

In response to Commissioner Molnar's examination at the hearing, Mr. Corcoran stated that one of NWE's objectives with its RFP was to diversify its supply portfolio so that PPL was no longer its sole or primary supplier and customers would not face the level of market risk that, in the past, accompanied the loss of large amounts of PPL-contracted supplies. Tr. p. 57. This NWE objective was responsive to the PSC's Default Supplier Procurement Guidelines, which encourage NWE to evaluate its resource needs in light of the diversity and flexibility within its existing portfolio (see ARM 38.5.8210), as well as the PSC's written comments on NWE's 2004 resource procurement plan, which encouraged NWE to immediately begin evaluating options for replacing the PPL contracts (see Docket N2004.1.15). Members of NWE's Technical Advisory Committee also suggested that NWE should consider the benefits of reducing PPL's market power when evaluating RFP bids. DR PSC-022(d) Attachment 1, p. 88.

Finally, Mr. Corcoran contended that while NWE was evaluating RFP offers, including PPL's, FERC decided to review PPL's market-based rate authority. Mr. Corcoran suggested that the FERC proceeding was a factor in NWE's resource procurement decisions at the time because NWE did not want to undermine the MCC's, PSC's and NWE's efforts to convince FERC to revoke PPL's market-based rate authority, which might have lead to cost-based prices. Tr. p. 65-66. Although it is true that FERC was reviewing PPL's market based rate authority at the same time NWE was discussing with PPL possible prices, terms and conditions for replacing the PPL-NWE contract set to expire in 2007, by the time FERC determined that PPL had failed the market power screen in September, 2005, NWE had already rejected PPL's slice offer in the RFP.

[1/] These load levels would increase by 1% per year.

In determining whether NWE acted prudently when it chose not to accept PPL's slice or requirements offers, the PSC must look to what NWE knew, or should reasonably have known, at the time. The record in this proceeding includes over 500 pages of documents related to NWE's 2004 RFP process. The evidence shows that Lands Energy and NWE performed economic analyses of PPL's offers compared to then-current market price projections and in combination with other potential resources to assess the overall impact on supply portfolio costs and risks. NWE's analyses were consistent with PSC rules and advice from the Company's advisory committee. NWE's decision to decline PPL's requirements offer appears reasonable given the various restrictions and limitations that impacted the total cost in uncertain ways and in light of its strategy to diversify its supply portfolio. NWE selected PPL's slice product, but ultimately could not negotiate what it felt was a reasonable price. While, in retrospect, the PPL's offered price for the slice product might appear attractive, record evidence does not support the idea that NWE acted imprudently by not acquiring the slice product, given circumstances at the time.

Financial swaps

During the hearing NWE witness John Hines explained that the stipulation requires NWE to withdraw from this consolidated docket its request for PSC approval to engage in financial swaps as one of its hedging tools. He stated NWE would discuss this issue in greater detail with MCC. If NWE, at a future date, decides to proceed with a request for PSC approval, MCC has agreed to file testimony in that docket on this subject. Accordingly, the PSC will have a foundation for future a decision. Tr. p. 11. On this issue, the stipulation continues the status quo and has no customer impact.

Staff Recommendation

As a whole, staff finds the stipulation reasonable in light an analysis of record evidence, prior PSC decisions and the positions of the various parties. As both NWE and MCC witnesses indicated, the stipulation represents a set of compromises that allow a resolution of the contested issues. Staff recommends that the PSC approve the stipulation with the one modification described in this memo regarding removal of real-time labor costs from the electric tracker upon issuance of an interim order in D2009.9.129.