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 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.	))))))	UTILITY DIVISION DOCKET NOS. D2008.5.45 and D2009.5.62

Direct Testimony
of
John W. Wilson
on Behalf
of
The Montana Consumer Counsel

September 18, 2009

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I. QUALIFICATIONS

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND ADDRESS.

A. My name is John W. Wilson. I am President of J.W. Wilson & Associates, Inc. Our offices are at 1601 North Kent Street, Suite 1104, Arlington, Virginia, 22209.

Q. PLEASE OUTLINE YOUR EDUCATIONAL BACKGROUND.

A. I hold a B.S. degree with senior honors and a Masters Degree in Economics from the University of Wisconsin. I have also received a Ph.D. in Economics from Cornell University. My major fields of study were industrial organization and public regulation of business, and my doctoral dissertation was a study of utility pricing and regulation.

Q. HOW HAVE YOU BEEN EMPLOYED SINCE THAT TIME?

A. After completing my graduate education I was an assistant professor of economics at the United States Military Academy, West Point, New York. In that capacity, I taught courses in both economics and government. While at West Point, I also served as an economic consultant to the Antitrust Division of the United States Department of Justice.

After leaving West Point, I was employed by the Federal Power Commission, first as a staff economist and then as Chief of FPC's Division of Economic Studies. In that capacity, I was involved in regulatory matters involving most phases of FPC regulation of electric utilities and the natural gas industry. Since 1973 I have been employed as an economic consultant by various clients, including federal, state, provincial and local governments, private enterprise and nonprofit organizations. This work has pertained to a wide range of issues concerning public utility regulation, insurance rate regulation, antitrust matters and economic and financial analysis. In 1975 I formed J. W. Wilson & Associates, Inc., a Washington, D.C. corporation.

Q. WOULD YOU PLEASE DESCRIBE SOME OF YOUR ADDITIONAL PROFESSIONAL ACTIVITIES?

A. I have authored a variety of articles and monographs, including a number of studies dealing with utility regulation and economic policy. I have consulted on regulatory, financial and competitive market matters with the Federal Communications Commission, the National Academy of Sciences, the Ford Foundation, the National Regulatory Research Institute, the Electric Power Research Institute, the U.S. Department of Justice Antitrust Division, the Federal Trade Commission Bureau of Competition, the

Commerce Department, the Department of the Interior, the Department of Energy, the Small Business Administration, the Department of Defense, the Tennessee Valley Authority, the Federal Energy Administration, and numerous state and provincial agencies and legislative bodies in the United States and Canada.

Previously, I was a member of the Economics Committee of the U.S. Water Resources Council, the FPC Coordinating Representative for the Task Force on Future Financial Requirements for the National Power Survey, the Advisory Committee to the National Association of Insurance Commissioners (NAIC) Task Force on Profitability and Investment Income, and the NAIC's Advisory Committee on Nuclear Risks.

In addition, I have testified as an expert witness in court proceedings dealing with competition in the electric power industry and on regulatory matters before more than 50 Federal and State regulatory bodies throughout the United States and Canada. I have also appeared on numerous occasions as an expert witness at the invitation of U.S. Senate and Congressional Committees dealing with antitrust and regulatory legislation. In addition, I have been retained as an expert on regulatory matters by more then 25 State and Federal regulatory agencies. I have also participated as a speaker, panelist, or moderator in many professional conferences and programs

dealing with business regulation, financial issues, economic policy and antitrust matters. I am a member of the American Economic Association and an associate member of the American Bar Association and the ABA's Antitrust, Insurance and Regulatory Law Sections.

II. OVERVIEW OF TESTIMONY

Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

A. I am presenting testimony in this proceeding on behalf of the Montana Consumer Counsel (MCC).

Q. PLEASE SUMMARIZE YOUR TESTIMONY?

A. My testimony pertains to NorthWestern Energy's ("NWE" or "the Company") proposed cost recovery under its 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.

Q. HAVE YOU REVIEWED THE COMPANY'S PROPOSED COST RECOVERY UNDER ITS ELECTRIC TRACKER FILINGS FOR THE TWELVE-MONTH PERIODS ENDING JUNE 30, 2008 AND

JUNE 30, 2009 AND FOR THE FORECASTED PERIOD ENDING JUNE 30, 2010?

A. Yes, I have. In addition to reviewing NWE's filings in this regard, I have also reviewed discovery responses provided by the company to data and information requests that have been made by the MCC and the Commission Staff.

Q. IS THE ELECTRIC SUPPLY COST RECOVERY PROPOSED BY NWE FOR THE 12-MONTH TRACKING PERIOD ENDED JUNE 2008 REASONABLE?

A. In my opinion 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.

III. ELECTRIC SUPPLY COST CHANGES

Q. HAVE THE COMPANY'S ELECTRIC SUPPLY COSTS CHANGED SIGNIFICANTLY OVER THE THREE TRACKER YEARS REFLECTED IN THIS PROCEEDING?

A. On an overall basis the electric supply costs reported by the Company have remained nearly the same. The Company's average electric supply cost in the 2007/2008 tracker year was $47.15/Mwh. In the 2008/2009 tracker

year the average cost increased slightly to $48.55/Mwh, and in the estimated 2009/2010 tracker year it returned to $47.06 – nearly the same average cost as in the 2007/2008 tracker year.

Q. HAVE THE COMPONENTS OF THE COMPANY'S ELECTRIC SUPPLY REMAINED RELATIVELY STABLE OVER THESE THREE TRACKER YEARS?

A. Yes. As shown in the table below, each of the major supply components accounts for approximately the same percentage of total electric supply in each of the three tracker years.

Q. HAVE THE COSTS OF EACH OF THESE SUPPLY COMPONENTS REMAINED THE SAME OVER TIME?

A. 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 2009/2010 tracker year. In contrast to this market cost decline, NorthWestern's costs of other supply components had offsetting increases so that the Company's overall average supply cost remained relatively stable. Details on the amount and

cost of each electric supply component are shown in the following table for each of the three tracker years.

Northwestern's Montana Electric Supply and Cost
2007 - 2010

	Tracker Year 2007/2008 (actual)		Tracker Year 2008/2009 (actual)		Tracker Year 2009/2010 (estimated)	
	%	$/Mwh	%	$/Mwh	%	$/Mwh
PP&L Contract	35.41%	45.55	35.43%	47.15	35.60%	48.75
Market Transactions	26.84%	59.27	27.49%	58.66	29.37%	40.76
CU4	13.18%	36.20	12.85%	49.01	11.34%	68.91
QF Contracts	12.70%	33.89	12.98%	32.36	12.96%	34.98
Judith Gap	7.95%	37.94	7.43%	39.86	7.47%	43.54
Other*	3.91%	77.29	3.83%	59.27	3.26%	65.31
Total	100.0%	47.15	100.0%	48.55	100.0%	47.06

* Includes: Tiber, J.P. Morgan, Powerex and Basin Creek.

IV. CLAIMED REVENUE LOSSES

Q. DOES THE COMPANY PROPOSE RATE ADDITIONS IN THE TRACKER FOR CU4 REVENUES THAT IT ESTIMATES WILL BE LOST DUE TO DEMAND SIDE MANAGEMENT ("DSM") CONSERVATION PROGRAMS?

A. Yes. The Company estimates that $164,523 of Commission-authorized CU4 revenues were lost in the 2008-2009 tracker year and that another $577,988 of Commission-authorized CU4 revenues will be lost in the 2009-2010 tracker year because of successful electricity conservation efforts under DSM programs.

Q. DOES THE COMPANY ESTIMATE THAT WITHOUT THIS ADJUSTMENT, CU4 REVENUES WOULD BE LESS THAN CU4 COSTS BECAUSE OF SUCCESSFUL DSM?

A. No. The Company's fixed cost of service revenue requirement for CU4 was determined by the Commission in Order 6925f in Docket No. D2008.6.69. The Company divided this annual fixed cost of service revenue requirement by 2007 test year kilowatt hours (kwh) sales to determine the per kwh charges that it includes in each customer's electric bill to cover the Commission's determined CU4 fixed cost of service of $75,832,029. Because 2007 test year kwh sales were less than actual kwh sales in tracker year 2008/2009 and less than estimated kwh sales in tracker year 2009/2010, CU4 fixed cost revenues in each of these tracker years exceed the Commission's determined annual CU4 fixed cost of service.

Q. THEN, WHY IS THE COMPANY PROPOSING RATE ADDITIONS IN THE TRACKERS FOR LOST CU4 REVENUES DUE TO DSM?

A. The Company's argument is that without DSM, kwh sales would have been even larger than they were, resulting in even larger CU4 revenue increments above the Commission's determined CU4 fixed cost of service. So as not to discourage the Company's enthusiasm for its DSM efforts, the Company is asking the Commission to add back this lost surplus revenue as additional allowed tracker revenue, even though it is in excess of the Commission-determined CU4 fixed cost of service.

Q. HAS ACTUAL CU4 SUPPLY EXCEEDED THE AMOUNT THAT WAS ANTICIPATED BY THE COMPANY AND THE COMMISSION IN DOCKET D2008.6.69?

A. No. Beginning in April of 2009 and continuing through the present, CU4 has experienced a lengthy and unexpected outage, and generation supply from the plant has been, and is now expected to be, significantly lower in the 2008/2009 and 2009/2010 tracker years than the Company and Commission anticipated in Docket D2008.6.69. Reduced sales of CU4 production are attributable to this outage, not to DSM. The lost sales that the Company 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. Since the Company derives its CU4 fixed cost of service

recovery from a surcharge on all sales (not just sales of CU4 output) and, as NorthWestern contends, DSM has reduced these total kwh sales from what they might have been without DSM, the Company is requesting a tracker adjustment for additional CU4 revenue, even though total kwh sales have increased from the 2007 test year amount and the Company is therefore already recovering more than the $75,832,029 CU4 fixed cost of service as determined by the Commission in Docket D2008.6.69.

An alternative point of view may be that since the Company is already collecting more than the Commission's determined CU4 fixed cost of service, providing for further additional CU4 revenue in the tracker is unnecessary. The requested revenue increment might also be deemed inappropriate in view of the plant's extended outage and the fact that consumers are already paying the costs of additional replacement supply to make up for the outage, and their revenues are already more than covering the full CU4 fixed cost of service.

V. INCLUDING IN-HOUSE LABOR COSTS IN THE TRACKER

Q. IS THE COMPANY OFFERING A NEW PROPOSAL TO BEGIN INCLUDING CERTAIN IN-HOUSE LABOR COSTS IN THE TRACKER?

A. Yes. Until the end of 2008 the Company 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 the Company's tracker filings through 2008. At the end of 2008 (December 28), the Company began performing the required real time scheduling for its system with its own employees. Relatedly, it also made offers to several of the former consultant's employees to become company employees. The Company is now proposing to include its allocated internal labor and administration costs of real time scheduling as tracker costs.

Q. WOULD THIS BE A SIGNIFICANT CHANGE?

A. Yes. NorthWestern has never before recovered any of its own internal labor or administrative costs associated with energy supply through its tracker filings.

Q. HAS THE COMPANY PREVIOUSLY PROPOSED TO RECOVER SUCH INTERNAL LABOR AND OVERHEAD COSTS ASSOCIATED WITH ENERGY SUPPLY THROUGH ITS TRACKER FILINGS?

A. Yes. In Docket No. D2005.5.88 the Company proposed to include staff labor costs associated with new DSM program employees in its electric

tracker revenues. In that case, I testified that these kinds of 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. It is inconsistent with long established test year ratemaking principles, as well as 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. Such a practice 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. That would undermine and destroy sound and venerable ratemaking procedures that have been carefully developed, implemented and upheld by regulators over many decades. It would also motivate regulated utilities to avoid and delay important general rate investigations, which look evenhandedly at all cost and price changes, in favor of one-sided interim procedures that track cost increases but not reductions.

Q. DID THE COMMISSION AGREE WITH THE ARGUMENTS TO THIS EFFECT IN DOCKET NO. D2005.5.88?

A. Yes. In Final Order No. 6682d, the Commission stated:

> "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."

Q. SHOULD THE COMMISSION CONTINUE TO UPHOLD THESE SAME REGULATORY PRINCIPLES IN THIS CASE?

A. Yes. In this case the Company has advised that it will be making a general rate case filing very soon. Issues regarding internal staff labor costs should

be considered in a comprehensive and balanced way in this general rate case filing and should not be recovered through the electric tracker.

If, in view of the fact that real time scheduling costs were included in the tracker while these functions were performed by consultants, the Commission nevertheless determines that it is fair to provide NorthWestern with additional scheduling cost compensation for the in-house period prior to the time that new general rate case rates become effective, such bridge compensation should be limited to $27,000 per month since that is the tracker cost amount that the consultant (Highland Energy) was being paid through December 28, 2008. This is less than the labor cost that NorthWestern is claiming in this case for the period in which its own employees have taken over real time scheduling.

VI. FINANCIAL SWAPS

Q. IS NORTHWESTERN REQUESTING THAT THE COMMISSION APPROVE ITS USE OF FINANCIAL SWAPS ("FIXED-FOR-FLOAT") TO PROCURE ELECTRIC SUPPLIES TO BE INCLUDED N FUTURE TRACKER FILINGS?

A. Yes.

Q. HOW WOULD THESE FINANCIAL SWAPS WORK?

A. The financial swaps that NorthWestern is proposing in this case are financial derivative transactions. Under such fixed-for-float deals NorthWestern would agree 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 would agree to pay NorthWestern the actual market price in that future time period for the same specified quantity of electricity. These would be purely financial transactions (financial hedges) without any physical sales of electricity actually taking place. Thus, if the negotiated price is $50/Mwh and the market price in the future period turns out to be $30/Mwh, NorthWestern would pay the other party the net amount of $20 for each Mwh of the specified contract quantity. In that case, whereas NorthWestern 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 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, NorthWestern would collect the $20 net amount from the other party for each Mwh of the specified contract quantity. In that case, NorthWestern 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. Of course, it is unlikely in the real world that winning and losing swaps will exactly offset each other, and the counter parties who would do the swaps with NorthWestern are highly sophisticated and practiced trading experts who are not in business to break even.

Q. HAS NORTHWESTERN ESTABLISHED A TRACK RECORD USING FINANCIAL SWAPS IN CONJUNCTION WITH ITS NATURAL GAS SUPPLY ACTIVITIES?

A. Yes. Mr. Markovich testifies in this case that NorthWestern 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.

Q. DO YOU AGREE THAT FINANCIAL SWAPS HAVE WORKED WELL FOR THE COMPANY AS REGARDS GAS SUPPLY?

A. That depends on how one defines "working well." If, as Mr. Markovich suggests, 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 for NorthWestern's gas customers. As shown in response to data request MCC-037(a), NorthWestern'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%. Looking at a longer period, my colleague, George L. Donkin recently estimated that NorthWestern's fixed price deals resulted in above market gas costs of about $26.9 million over the period November 2005 through June 2009.

In view of this track record on the gas side of NorthWestern's business, the Commission may think better than to give the Company 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 NorthWestern has encountered in its fixed-for-float gas price transactions.

Q. DOES THIS COMPLETE YOUR PREPARED DIRECT TESTIMONY AT THIS TIME?

A. Yes; it does.