Monica J. Tranel, Esq.
TRANEL LAW FIRM, P.C.
Great Northern Town Center – Empire Block
30 W. 14th Street, Suite 204
Helena, Montana 59601
(406) 513-1108
mtranel@tranelfirm.com

Attorneys for Intervenor Montana Consumer Counsel

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

* * * * *

IN THE MATTER OF the NorthWestern	)	REGULATORY DIVISION
2011 – 2012 Electricity Supply Tracker	)	
	)	DOCKET NO. D2012.5.49

MONTANA CONSUMER COUNSEL
RESPONSE BRIEF
"REDACTED"

Montana Consumer Counsel (MCC) submits its Response Brief in this docket.

I. INTRODUCTION AND BACKGROUND.

NorthWestern Energy (NWE, or the Company), submitted its annual electric default supply tracker filing on May 31, 2012. As required in tracker proceedings, NWE's application requested approval of rates to reflect rate treatment for the following: 1) the balance in the Electric Supply Deferred Cost Account for the historical 12-month period ending June 30, 2011; 2) CU4 variable costs and credits; 3) Dave Gates Generating Station [DGGS] variable costs and credits; and 4) projected load, supply and electric costs for the subsequent 12-month period ending June 30, 2012. For the typical residential customer, the Company projected a net increase of $2.62 per month, or $31.44 per year, a 5.94 percent increase, in supply related costs.

The Commission entered Interim Order No. 7219a on July 19, 2012, approving implementation on an interim basis of a Deferred Supply Rate designed to recover the under-collection for Electricity Supply Costs of $11,496,428, to refund the over-collection for CU4 variable costs/credits of ($2,993,971), and to refund the over-collection for DGGS variable costs/credits of ($1,861,161) over the 11-month period ending June 30, 2013. Procedural Order No. 7219b was issued on July 27, 2012 and was later modified by Procedural Order No. 7219e.

On March 22, 2013 MCC submitted its pre-filed direct testimony. MCC witness Dr. John W. Wilson generally observed that preapproval of certain costs of the DGGS plant and its operation, despite the plant's relatively high costs compared to market regulation service, might reasonably allow for the recovery of replacement regulation service costs up to the total cost of owning and operating DGGS, but does not allow for recovery of full DGGS plant and operating costs plus the costs of replacement service. Exhibit MCC-1b[1], p. 9-10. Dr. Wilson recommended disallowing $1.4 million in replacement power costs as 1) outside the scope of preapproval; and 2) not prudent as measured by NWE's actions in December of 2010.

MCC witness George Donkin noted that NWE's off system fixed price hedges should be terminated as they cover only a small percentage of NWE's supply; they

[1] Dr. Wilson's testimony is submitted as 1a for the redacted, or public version; and 1b for the protected or confidential version.

have produced enormous losses in a short period of time; and the Company lacks incentives to produce hedging gains for ratepayers, or even to mitigate hedging losses. Exh. MCC – 2 p. 18:6-18.

A hearing was held June 11 – 14, 2013.

II. SUMMARY

MCC requests the following relief:

A) Disallowance of $1.4 million in replacement power costs while DGGS was off line; and

B) Termination of NWE's off system fixed price transactions.

A. <u>DGGS</u>

"[W]hat we're trying to do is turn a lemon into lemonade here." Testimony of William Rhoads, TR. p. 114:14-15. Ratepayers should not be charged for both the full costs of operating DGGS as well as the incremental costs of replacement services while the problem is being addressed. Secondarily, NWE's failure to assess the availability and cost of replacement power insurance prior to commencing commercial operation of DGGS was not prudent. All replacement power costs from the DGGS outage should be borne by shareholders and not ratepayers.

B. <u>Hedging Losses</u>

NWE's off system fixed price hedging transactions are not cost effective, they are not needed, and they should be terminated.

MCC has great concerns regarding lost revenue recovery and particularly lost revenue recovery applied to USB programs. Nonetheless, MCC recognizes the Commission has allowed for lost revenue recovery in the past and the Company agreed in this docket with MCC that lost revenue recovery for DSM efforts in NWE's own facilities is inappropriate.

III. ARGUMENT

A. DGGS

1. *Preapproval was for the cost to build DGGS; not for DGGS plus replacement power if DGGS turned out to be a lemon.*

DGGS provides regulation service at (by far) the highest cost level in the entire electric utility industry.[2] The Commission approved these high costs (over MCC objection) because of NWE's unique circumstances.[3] NWE sought and received pre-approval to build a very unique plant; a *pioneer* in the field. DGGS is atypical: as NWE states with pride, this kind of plant is a first of its kind in the world.

The ratepayers of Montana paid $81 million dollars[4] to have DGGS provide regulation service; they should not be forced to pay an additional $1.4 million for regulation service to replace the unavailable service they spent $81 million to obtain. Preapproval assured NWE that prudently incurred costs to build DGGS would be recoverable. It did not assure, nor did it imply, that DGS costs plus additional costs to

---

[2] See MCC-1b; also TR. p. 603:7-17.
[3] Note that NWE had no trouble purchasing replacement regulation service and that the cost of these replacement purchases was far below regular DGGS regulation service costs.
[4] TR. p. 51:8-12; 54:18 – 55:10.

purchase regulation power would be recoverable, especially so soon after first beginning to provide service.[5]

To now experience a DGGS outage that is unrelated to maintenance and in the infancy of the plant's life and then to ask ratepayers to continue paying DGGS costs plus additional costs for replacement makes the ratepayers responsible for the lemon. The Company's cost recovery should be capped at what total DGGS cost levels would have been (fixed costs plus fuel and operating costs) without an outage.[6] There were no fuel and operating costs over the outage period. Therefore, the cost recovery limit should be DGGS fixed costs (which did continue unabated during the outage) plus that portion of replacement costs up to what fuel and operating costs would have been under normal circumstances. The excess above full normal DGGS costs ($1.4 million) should not be charged to ratepayers. This outcome is consistent with the FERC law judge in its decision on DGGS, with the following determination:

> "No party objects to a revision of the NorthWestern Schedule 3 language intended to allow a pass through of third party contracts that are less than the variable costs of operating DGGS. The more controversial proposal is to allow a pass through of third party contract costs in the event of a DGGS outage.….I find that the

[5] Indeed, the record in this case demonstrates that NWE originally doubted its ability to recover these costs. "According to notes of its meeting with PWPS on April 19, 2012, NWE's Vice President and General Counsel described that **[begin protected material]** [redacted] **[end protected material]** (See Response to Data Request PSC-008c at 122 of 127; also Exh. MCC – 1b p. 11.)

[6] The Company was granted prior approval by the Commission for the recovery of certain costs of the DGGS plant and its operation. This approval was granted by the Commission despite the plant's relatively high costs in comparison with the market regulation service purchases that it replaced. This prior approval was granted with the expectation that it would protect ratepayers against the risks of regulation service availability and potentially higher regulation service purchase costs that might occur in the future if market supplies were limited. While it may be reasonable to allow for the recovery of replacement regulation service costs up to the total cost of owning and operating the DGGS plant, it is not reasonable to charge ratepayers a greater amount, including both full DGGS plant and operating costs and the incremental costs of replacement service. Exh. MCC-1b p. 9.

> proposed revisions to Schedule 3 quoted above by NorthWestern are not just and reasonable and that third party contract costs should be passed through only if the costs are lower than the variable costs of operating DGGS."[7]

Section 69-3-201, MCA requires that every charge made by any public utility shall be reasonable and just. In addition, expenses included in rates must be prudently incurred. These ratemaking standards comport with utility ratemaking principles generally, including principles applied by the FERC and generally adopted by the states.

Prudence is a regulatory standard that obligates the Commission to disallow costs and expenses that have been imprudently incurred, as the ratepayers of Montana have no choice about where they take their business, and the only motivation NWE has to act prudently is to face disallowance when warranted. See e.g., *Re: Long Island Lighting Co.*, 71 PUR 4th 262, 266 (N.Y.P.S.C. 1985); accord *Wisconsin Public Service Corporation*, 86 PUR 4th 357, 377 (Wis. P.S.C. 1987) (utility management must use the same vigor to protect ratepayers as it does to protect shareholders).

NWE bears the burden of ultimately demonstrating that the costs it wishes to pass on to its captive customers in Montana were prudently incurred. See, *Re: Central Vermont Public Service Corporation*, 83 PUR 4th 532, 566 (Vt.P.S.B. 1987). Although there is a presumption that management has acted prudently, NWE retains the burden of persuasion that its actions were, in fact prudent. *Id.*, also *Re: Southern California Edison Company,* 116 PUR4th 365, 375 (Cal. P.u.C. 1990).

[7] See paragraphs 223-225 of the FERC Presiding Administrative Law Judge's Initial Decision issued September 21, 2012 in FERC Docket Nos. ER10-1138-000 and ER12-316-000; also Exh. MCC-1b p. 11-12.

To adequately bring market forces into the analysis, some Commissions apply the "capable executive" standard, meaning that the decision under review must be reasonable when viewed against the decision and courses of conduct of other corporations that make investment decisions of comparable size and complexity." *Re: Northern Utilities, Inc.*, Docket No. 95-480 and 95-481, slip op. at 5 (Maine P.U.C. August 9, 1996); accord *Gulf States Utilities Co. v. La. Pub. Service Comm.*, 689 So.2d 1337, 1346 (La. 1997)(adopting objective reasonableness standard). NWE itself testified that the "*risks don't change* in terms of an independent power producer running this plant versus a regulated utility in terms of the need to keep the plant in operation. But the financial models that are used by the two distinct entities may be different." TR. p. 322:19-23.

For this very reason, to protect the ratepayers from becoming the default insurers for the utility, Commissions have required that management of a large construction project undertaken by a regulated utility should be no less rigorous or less oriented toward cost minimization than management of a large project in an unregulated industry. As the New York Commission recognized, this standard "provides the most fair and reasonable basis for evaluating the record in this case." *Long Island Lighting Co.*, 71 PUR4th at 271.

Applying the objective reasonableness standard is especially appropriate in the context of preapproval. Inclusion of other non-regulated industries for comparison prevents NWE from benefitting from imprudently incurred costs, which it has less incentive to avoid when functioning under the Commission's preapproval of costs to build in the first instance. When reviewing costs in the context of preapproval, the Commission must be especially vigilant in its review and analysis of whether costs were prudently incurred. Management must be held to the same standard for ratepayers that it uses to protect shareholders. *Re: Wisconsin Public Service Corp.*, 86 PUR4th 357, 377 (Wis. P.S.C. 1987).

As NWE aptly stated "we're trying to [..] turn a lemon into lemonade here." TR. p. 114:14-15. This Commission approved NWE's cost to build a plant that worked; not to build one that would be entirely out of service in roughly a year. Montana ratepayers paid once for power from this plant; it is wrong to ask them to pay a second time for power that DGGS was built to, but failed to provide.

NWE went to the Commission seeking preapproval for a generating station that produced 30 MW or more per minute, per unit "to respond to regulated significant variations in system generation and load." TR. p. 53:15 – 54:8. Ratepayers paid approximately $81 million for a generating station that would produce 30 MW or more per minute per unit. *Id.*, TR 54:22-24. **[Begin protected material]** [redacted]. **[End protected material]** TR. p. 64:17-20. NWE instituted the operational change to run the units at 15 MW per minute after the failure of the units in early 2012. TR. p. 65:6-23; 66:22-25; p. 77:5-9.[8]

[8] **[Begin protected material]** [redacted]

To obtain preapproval NWE also represented to the Commission that DGGS would enable it to meet federal Control Performance Standard criteria.[9] Brief p. 8. It is undisputed that since DGGS became operational, NWE's compliance with those standards was higher during the months that DGGS was off line than during the months that DGGS was operational.[10]

NWE can't reasonably expect the ratepayers of Montana to pay for the plant while it isn't working and replacement power that the plant should, but is unable, to produce. Incremental costs for replacement power of $1.4 million should be disallowed.

2. *<u>NWE's failure to look into outage insurance was not prudent.</u>*

One month prior to taking the Dave Gates Generating Station commercial, NWE knew:

- That **[begin protected material]** [redacted] **[End protected material].** TR. p. 60:14-18. 22-24; 61:1-3.
- DGGS was a unique plant, something NWE took much pride in, the first in the country built with its particular design criteria. TR. p. 52:12 – 53:1. DGGS was "a pioneer for anyone in the field." TR. p. 210:8-9.
- The facility was pre-approved by the Commission on NWE's representations that it would be available 24 hours a day, 365 days a year.

[redacted]**[End protected material].** Any argument that NWE's failure to look into insurance options based on the actual problem being different than the expected problem is akin to saying that a car wasn't a lemon because anticipated problems with the transmission didn't come to pass, even while all the wheels came off.

[9] Exh. MCC-13 p. 6

[10] *Id*.

TR. p. 53:2-9. NWE's purchase order with Pratt and Whitney Power Systems [PWPS] was part of NWE's preapproval application. TR. p. 211:8-9.

- PWPS was not liable under its contractual agreement with NWE to contribute to costs of replacement power if DGGS was off. TR. p. 199:22 – 200:5.
- In the event of an outage, costs associated with replacement power could run into the millions of dollars.[11]
- NWE knew that in the regulated power production industry "catastrophic failures [..] would occur" and that "when you have a major problem like this, it will be severe." TR. p. 219:2-3; TR. p. 235:15-18. NWE identified three specific plants where outages went on for some time, in one case "it took us months and months to get that powerhouse cleaned up." TR. p. 218-220:6-7. NWE acknowledges that it understood that equipment failures were possible. Brief p. 8. NWE senior management encourages the Company "to continue to pursue a fix over a year or two-years' time frame […]." TR. p. 249:10-13.

[11] NWE went to great lengths to explain why sophisticated parties to contract negotiations avoid the enormous risks associated with potential replacement power costs. Brief p. 14. NWE, with preapproval in hand, was not motivated to avoid the huge costs of an outage. With Montana ratepayers functioning as NWE's default insurers, the Company had no incentive to avoid incurring costs associated with a shutdown that "can be for many months or even years and even eventually require the construction of a whole new replacement facility." Brief p. 14 quoting NWE's expert witness on contract negotiations. NWE has no qualms about asking the ratepayers of Montana to pay for costs incurred from a risk that "major manufacturers are just not willing to take." Brief p. 16, quotations in original.

- Outage insurance was available in the industry, and something that NWE itself had looked into with respect to other facilities it had an interest in. MCC 14, 15; TR. p. 208:25 – 209:2.
- Coverage for a plant like DGGS would be much less costly than coverage for loss on a conventional plant because replacement cost is relatively low, because the product that DGGS produces does not have a high market value.[12]

In this context, NWE *decided not to look into* obtaining replacement power insurance for DGGS.

Q: [COMMISSIONER KAVULLA]: […] NorthWestern had not solicited pricing for that service [replacement power insurance], right?

A: [WILLIAM RHOADS]: That's correct.

Q: So we don't know what replacement power coverage would have cost in 2011 or in the time before the outage.

A: **No**.

Q: NorthWestern has not submitted evidence for that amount?

A: **Nor do we have evidence.**

TR. p. 208:14 – 24 (emphasis added).

NWE did not, and does not, know what the cost of replacement power insurance in 2010 would have been. NWE's failure to obtain a price and make a decision regarding

[12] TR. p. 581:17 – 582:10.

the costs and the risks involved was not prudent. NWE's argument on this point is that "it is common knowledge in the industry that outage insurance is uneconomical" and "typically not procured." Brief p. 7. This argument is unsupported,[13] untrue[14] and especially unavailing where, as here, the utility is dealing with an uncommon plant that is a *__pioneer in the field__*, and by definition atypical.[15]

NWE's applies an *ex post facto* argument that replacement power would not have been cost effective.[16] The analysis of whether management acted prudently is viewed under the circumstances at the time the decision was made; not with hindsight. See, *New England Power Co.*, 31 FERC ¶ 61,047, *reh. denied*, 32 FERC ¶ 61,112 (1985). NWE asks this Commission to apply a legal standard to its actions that it rejects under any other circumstance: hindsight. NWE's *own expert* on this issue testified that "the quantity and value of replacement energy, based upon the duration of an outage, would be *unknowable* at the time the contract is negotiated." Brief p. 16 (quotations in original; emphasis added). Management's actions are never reviewed for prudence under later acquired knowledge. NWE itself applies this legal standard. Brief p. 21.

---

[13] See TR. p. 588:23 – 5892; MCC-16; TR. 576:7-16.

[14] See TR. p. 576:7-19 ("ACE, a big European company that has a very big presence here in the United States insures 10 percent of the US market. They have 100,000 MW of generation insured for replacement power." Also TR. p. 592:13-24; 593:23 – 594:1.

[15] MCC's expert Dr. Wilson testified that the fact that DGGS is providing regulation service would actually make an insurance premium less expensive, since it is producing a product without a high market value and that is relatively inexpensive to replace. TR. p. 582:1-10.

[16] NWE goes to some length to explain how their action was industry standard, and relies heavily on information obtained more than two years after the point of decision to make its point about cost effectiveness. Brief pages 18-19. All this information was obtained after the fact, however, and is not relevant to the point in time when NWE made the decision to not look into or consider in any way the option of obtaining outage insurance. What is highly relevant is that **[begin protected material]** [redacted] **[end protected material]** and took no steps to mitigate the risk to ratepayers in light of those concerns. This is one of the ongoing costs of preapproval – utility apathy regarding costs to ratepayers as a project develops.

The Commission's analysis is based on what NWE knew in December of 2010 when it made the decision to not look into the cost of insurance for replacement power. As NWE itself poignantly argues, prudency "*is measured at the time decisions are actually made and not based on hindsight, especially speculative hindsight that lacks any factual basis*." Brief p. 26. By NWE's own standards, all of NWE's arguments regarding its later acquired knowledge should be disregarded. Certainly, in 2010 when the Company had serious concerns about DGGS's commercial operability, NWE did not know the <u>actual</u> cost of replacement power; nor did it know what replacement insurance would cost, because it didn't even obtain a quote for such insurance. It had no facts to base a risk assessment on; and made no such risk analysis. Such failure is not prudent, and should not be paid for by the ratepayers of Montana.

NWE argues that its failure to look into the price of replacement insurance is mitigated by the fact that it negotiated an extended warranty from PWPS. This argument takes the Commission off target. NWE's actions after the fact don't mitigate its failure to act prudently in December of 2010. *New England Power Co., id.* Even getting into the details of NWE's extended warranty, it applied only to the turbines; it was only for two years; it cost close to half a million dollars (a modest price, in NWE's words)[17]; and it has already expired.[18] The issue, however, isn't the cost of the warranty or whether or how NWE went about obtaining a warranty; the issue is whether NWE should have

[17] Brief p. 23; TR. p. 183:17 – 184:6.
[18] Brief p. 23; Exhibit NWE – 2, p. 16.

considered the option of obtaining insurance to cover replacement power in the event of an outage. NWE did not even consider looking into it. That was not prudent.

As a corollary, NWE's argument that PWPS provided ten million dollars of value to NWE by performing its obligations under the warranty is similarly unavailing (as well as completely speculative). PWPS did what it contracted to do. NWE's argument that the power turbines are more reliable "at no cost to the customers" (Brief p. 11) is specious. NWE's argument that ratepayers are "better off" is confounding. Carried to the extreme, ratepayers would be better off if the plant goes out every year, even after paying for replacement costs, so long as the warranty is extended`. It seems that ratepayers would be better off if the plant performed as promised, and warranties were not needed. PWPS did what NWE ratepayers paid it to do, through preapproval. NWE ought to have applied the same acumen to assessing the necessity for replacement power insurance that it applied to negotiating an extended warranty.

NWE argues that it minimized the cost of the outage. Brief p. 9. Minimizing the cost of the outage is a given, and completely irrelevant to the Commission's decision regarding the disallowance of $1,419,172 of replacement power. Further, the incurrence of these costs was at least partly attributable to NWE's own choice to not even look into the acquisition of replacement cost insurance. While admitting that it did not inquire into the possibility of outage insurance (brief at 3), NWE attempts to mollify the ratepayers by saying first that the cost was simply prohibitive while acknowledging they didn't know what the cost was; then argues next that substantial experience justified a failure to solicit information regarding a *unique, pioneer in the field* kind of plant.[19] Given the unique and unproven application of the DGGS plant, there was considerably greater reason to at least investigate insurance coverage in this case than in the case of a run-of-the-mill type of generating plant with a proven track record.

In addition to the incorrect claim that outage insurance is never obtained for fossil plants,[20] the Company, despite admitting to having never looked into such insurance, speculates wildly about how expensive they imagine it would be. Starting with an assumed and entirely undocumented guess that such insurance would cost "roughly $1 million"[21] the Company compounds its speculation by suggesting that since DGGS is a regulation facility rather than a load serving plant, coverage for this plant "is likely much more expensive.[22] Such contrived excuses for failing to consider insurance are evidence of nothing and are merely self-serving speculation.[23] It is certainly not persuasive evidence of prudent action on NWE's part.

---

[19] "While it is true that NorthWestern did not inquire about outage insurance here, there is no obligation to inquire when you know the answer based on your substantial experience." (Brief at 20) But, the Company's claims that it knew that insurance was not available and (if it was) it was too expensive, are entirely contrived fiction without any foundation.

[20] See footnotes 11 and 12, *supra*.

[21] TR. p. 208; PSC-008 (c), attachment 8.

[22] Actually, it would be far more logical to speculate that replacement coverage for DGGS regulation service would cost far less than coverage for a load serving plant because regulation replacement costs are far below the replacement costs for generating capacity that is dispatched at typical load factors to serve normal generation needs.

[23] A particularly glaring example of the contrived nature of the Company's insurance arguments is presented in the first paragraph on page 17 of their brief, which begins with the bizarre assertion that it is "common knowledge" that replacement cost insurance is not cost effective and ends with the conflicting assertion by their witness that in 37 years he never even encountered such an insurance policy. On page 20 of the Company's brief, the same witness who never encountered such a policy is quoted opining on the deductibles and exclusions in such (unencountered) policies, which in his experience are "neither available nor obtained." Such uninformed and self-contradicting testimony cannot be considered competent evidence in this proceeding.

Knowing that DGGS's ability to go commercial was in serious question; knowing that DGGS was unique, a never-before been built plant; knowing that the facility needed to be on 24 hours a day and that this is what Montana ratepayers paid for; knowing that no recourse was available from PWPS; and knowing that outage insurance was available in the industry; NWE chose not to inquire into the availability or economics of replacement power insurance. That failure was not prudent. Costs of $1,419,172 should be disallowed and not recoverable from the ratepayers of Montana as a result of NWE's imprudence.

B. Supply Portfolio: Hedging.

The undisputed evidence before the Commission establishes:

- In 2011 – 2012 the actual losses from NWE's hedging practices were $16,920,348. [24]
- From 2012 – 2013 the actual losses from NWE's hedging practices were $19,889,593.[25] This is $4,956,885 above the previously projected losses for this same period.
- Actual losses from NWE's hedging practices from 2011 – 2013 are **<u>$36,809,954.</u>**
- An additional $10.5 million of off-system hedging losses are projected in the 2013 – 2014 tracker period.[26]

---

[24] TR. p. 424.
[25] TR. p. 430.
[26] TR. p. 433.

- NWE concedes and confirms in its Brief that it will incur off-system hedging expenses, or losses as characterized by MCC, of $47.2 million. Brief pp. 29-30. This argument demonstrates that additional, significant off-system hedging losses over and above the $36.8 million of actual losses during the 2011-2012 and 2012-2013 tracker periods – are projected by NWE for the 2013-2014 tracker period. Brief p. 31.

NWE justifies its hedging practices on the argument that it is "intended to protect against unfavorable outcomes, yes." TR. p. 444:2-6. NWE agrees with MCC that paying high rates is "an unfavorable outcome to the customers, yes." TR. p. 444:20 – 445:4. NWE's hedging practices have resulted in at least $47.2 million dollars being passed on to ratepayers in Montana during the tracker periods 2011 through 2013 plus additional off-system hedging losses during tracker period 2013-2014. MCC is not asking in this docket for a disallowance of those off-system hedging losses; however, MCC seeks Commission direction in suspending or terminating such practices.

The record is clear that MCC is not asking the Commission to direct NWE to terminate all electric supply cost hedges. It must be emphasized here that the only hedges at issue in this case are the Company's off-system electric supply cost hedging transactions. For tracker period 2011 – 2012, the off-system electric supply price hedges amounted to only 8.9% of NWE's total electric supply (TR. p. 414), and on-system fixed-price hedges represented 85.2% of total electric supply (TR. p. 419). In its Brief, NWE argues that in subsequent tracker periods off-system fixed price hedges may represent

10% of total electric supply.[27] As MCC witness George L. Donkin explained in his pre-filed direct testimony in this case, NWE's off-system fixed price hedges are similar to the gas price swaps transactions the Company has used to hedge natural gas supply price volatility, at even greater losses, i.e., at least $80.9 million.[28]

MCC is asking the Commission to direct NWE to terminate its off-system electric supply price hedges for several reasons:

1. The Company's total electric supply portfolio is already significantly hedged; 75% in the foreseeable future. Thus, there is relatively little incremental benefit in moving the percentage hedged figure up to 85%. If past is prologue, potentially substantial cost savings will be realized from terminating off-system fixed-price hedges.
2. NWE does not seek to realize gains from its off-system hedging contracts; hedges are only used to promote greater price stability, with the specific recognition that the end result may produce greater costs than would obtain had its supplies been purchased at prevailing market prices. Under these circumstances, NWE is more likely to be the loser over time in its hedging deals with counter- parties, who seek to win their bets with NWE.[29]
3. The counter-parties in NWE's off-system, fixed-price hedging deals are putting their own money at risk, with hedging gains and hedging losses flowing

[27] Brief p. 33-34.
[28] Exh. MCC-2, p. 14.
[29] Exh. MCC – 2, p. 17.

straight through to the bottom line on their income statements. This is not the case with NWE, whose hedging losses or gains flow straight through to its ratepayers in supply cost tracker filings. This consideration also suggests that the counter-parties to the Company's hedging deals may have a greater incentive to win their hedging bets with the Company.[30]

4. As Mr. Markovich testified at the hearing, the counter-parties in NWE's off-system, fixed price hedges are much more sophisticated than NWE at "knowing market fundamentals, valuing risk, taking positions," and they also "have superior technical modeling skills."[31] This places NWE at a significant disadvantage in its hedging transactions with counter-parties, and explains, in part, why hedging losses have been the norm on the NWE system.

The Company defends its hedging strategies that, for the three tracker years discussed at the hearing, have a cost of $47.2 million, by dismissing MCC's argument as focusing "solely on the money involved in the transactions." (Brief at 29-30). NWE argues, in the manner of doublespeak, that the unfavorable outcome of increasing rates to accommodate NWE's hedging practices should not be viewed as a "loss" to ratepayers, but as a "value," and that Montana's ratepayers should not focus "solely on the money." NWE's cavalier discussion of the asymmetrical risk of price swings, without any assessment of the probability of various outcomes, should give the Commission serious

[30] Exh. MCC-2 p. 17-18.
[31] TR. p. 473.

pause about the rigor of the analysis. NWE cannot seriously claim that insurance is an absolute good with standalone "value" without regard to the corresponding cost, especially in light of its decision to not consider the <u>availability</u> of insurance in the context of replacement power. A cost-benefit analysis is appropriate and prudent in both cases.

Second, the Company asserts that the $47.2 million price tag is the "value" of the hedges to consumers. As the Company struggles to argue on page 30 of its brief, this "value" can be clearly appreciated if we realize that while today's price of $35 could drop to $2 (a decline of $33), it could also rise to $300 (an increase of $265). This "asymmetrical" nature of the risk proves the leveraged value of the hedge that is realized (paid for) by consumers. As the gap of the price of the hedge over the price of market power grows wider, the "value" to consumers is higher, by NWE's logic. Extending the logic of NWE's argument, consumers receive more "value" as hedging losses mount. Consumers would benefit more by spending less money on their monthly bills rather than paying real dollars for the "value" of NWE's hedging losses.

Third, NWE asserts that we should think about it like insurance (not costly outage insurance – but 47 million dollar hedging insurance.) Again, as the Company strives to explain, if NWE didn't do hedging a full 25% of supply would be at risk for price fluctuation. With hedging, 15% is at risk. The Company's highly creative dollar "value" rationalization is set forth at pages 30 – 33 of its Brief:

> NWE incurred almost $900 million of electricity supply costs over the three tracker years. Over the same period, it paid $47.2 million for insurance to hedge 10% of that supply ($90 million[32]) against volatility risk. While at first blush this may seem like expensive insurance, it is expensive only if one ignores asymmetry. That is, if the $35 price were to go to $500, that would be a 14-fold increase, and then instead of $90 million we would be talking about $1.26 billion of exposure. Suddenly a $47 million insurance premium doesn't seem so bad, does it? And, unlike costly outage insurance, this hedging insurance is not only based on market prices, it is also readily available.

NWE advances the position that its hedging practices should be governed by the prudence standard. Brief p. 28-29. This argument contains two problems. First, MCC is not requesting a disallowance of the $36 million in hedging losses over the last two years. Secondly, the statutory scheme NWE cites as a defense of its hedging practices contemplates a review of NWE's actions beyond a prudence standard alone. Section 69-8-201(1), MCA is subject to the provisions of § 69-8-419, MCA which obligates NWE to provide electricity to Montana ratepayers "at the lowest long-term total cost." Section 69-8-419(2)(a), MCA. Applying the requirements of §69-8-419, MCA, NWE off-system fixed price transactions should be terminated because they do not provide electricity supply at the lowest long-term total cost.

[32] The actual amount is well below $90 million because the hedged market purchases are priced well below average supply cost.

NWE's historical use of off-system price swaps/hedges as an effort to mitigate electric supply price volatility should be discontinued.

IV. CONCLUSION.

The Commission should disallow the requested $1.4 million costs of replacement power while DGGS was off line; and direct NWE to terminate its off-system fixed price transactions.

DATED this 14th day of August, 2013.

TRANEL LAW FIRM, P.C.

By: ______________________________

Monica J. Tranel
Attorneys for Montana Consumer Counsel
P.O. Box 201703
111 North Last Chance Gulch
Helena, Montana 59620-1703