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

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| IN THE MATTER OF NorthWestern Energy's Application for Approval to Purchase and Operate PPL Montana's Hydroelectric Facilities, for Approval of Inclusion of Generation Asset Cost of Service in Electricity Supply Rates, for Approval of Issuance of Securities to Complete the Purchase, and for Related Relief | ) | REGULATORY DIVISION<br><br>DOCKET NO. D2013.12.85 |

# Additional Issues Response Testimony

**of**

**John W. Wilson**

**on behalf of**

**The Montana Consumer Counsel**

May 30, 2014

***J.W. Wilson & Associates, Inc.***
**Economic Counsel**
**1601 North Kent Street · Rosslyn Plaza C · Suite 1104 Arlington, VA 22209**

**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. DID YOU SUBMIT DIRECT TESTIMONY ON APRIL 27, 2014 IN THIS CASE ON BEHALF OF THE MONTANA CONSUMER COUNSEL (MCC)?**

A. Yes; I did.

**Q. WERE YOUR QUALIFICATIONS SUMMARIZED IN THAT DIRECT TESTIMONY?**

A. Yes; they were.

**Q. WHAT IS THE PURPOSE OF THIS RESPONSE TESTIMONY?**

A. The purpose of this additional issues response testimony is to respond to certain testimony and recommendations that were presented in this proceeding in the Additional Issues Testimony and Exhibits filed by NorthWestern Energy ("NWE") witnesses.

**Q. WHAT ARE THE ADDITIONAL ISSUES THAT YOU ARE ADDRESSING?**

**A.** In response to the Montana Public Service Commission's April 4 Notice of Additional Issues, which directed NWE to provide testimony on the potential ranges of future capital expenditures and the effect of those expenditures on supply portfolio costs, NWE has stated that it understands that every possible future exposure cannot be identified and that unplanned events could occur. In recognition of that uncertainty the Company has presented additional cost comparison analyses, which it says reflect "extreme" scenarios in which (1) future capital expenditures on the hydros are increased by 30 percent above the level assumed in NWE's original filing and (2) future capital expenditures are decreased by 15 percent below the level originally assumed. The Company says that these extreme capital expenditure assumptions consider the range of capital expenditure variance that might occur annually, but which is highly unlikely.

The Company then compares projected electricity costs with the new capital expenditure ranges against specified market price and carbon cost assumptions, and concludes that the new comparisons show ranges that continue to compare favorably for the hydros and therefore justify the Commission's approval of the proposed hydros acquisition.

**Q. DO YOU BELIEVE THAT THE COMPANY'S SPECIFICATION OF THIS EXTREME BUT "HIGHLY UNLIKELY" RANGE OF FUTURE CAPITAL EXPENDITURE VARIANCE IS USEFUL IN THIS CASE?**

**A.** Yes. I believe that the identification of this range by the Company can be useful in arriving at an accommodation that would provide ratepayers with future cost protection that was absent in the Company's original filing.

**Q. PLEASE EXPLAIN HOW THIS FUTURE RATEPAYER COST PROTECTION COULD BE IMPLEMENTED.**

**A.** In response to PSC data request 223a I suggested that an incentive range could be implemented with respect to unforeseen future capital expenditure requirements for the hydros. For example, NWE requested approval of its proposed purchase of the hydros based on the assumption of an $8.5 million annual capital expenditure amount (escalated) from 2018 forward, and I suggested a $10 million annual cap on this capital expenditure amount. Using this cap I responded to PSC data request 223a that a range could be established around NWE's $8.5 million proposal from $7 million to $10 million, with NWE being allowed to retain cost savings below $7 million and with disallowance of amounts over $10 million.

In my opinion the Company's extreme range that NWE has now identified and analyzed in its additional issues testimony would be a reasonable alternative range for establishing a system of symmetrical incentives as suggested in PSC-223a. The establishment of this range for allowable future additional capital expenditures on the hydros would not only provide ratepayers with some future capital expenditure cost protection but it would also reward NorthWestern with incentives as an inducement to constrain future capital expenditures to necessary projects at cost-effective levels.

**Q. WOULD THE ESTABLISHMENT OF THIS SYMMETRICAL INCENTIVE RANGE FOR FUTURE CAPITAL EXPENDITURES PROVIDE RATEPAYERS WITH SUFFICIENT PROTECTION AGAINST THE FUTURE COST UNCERTAINTIES THAT ARE REFLECTED IN THE COMPANY'S ADDITIONAL ISSUES TESTIMONY AND EXHIBITS?**

A. It is a significant step, but there is one further cost uncertainty that is fundamental to the analysis in NWE's Additional Issues Testimony that I believe the Commission should consider in conjunction with the capital expenditure range that NWE has identified (at line 21of Additional Issues Exhibits TEM-3 and TEM-4) in its Additional Issues Testimony. This further cost uncertainty, as depicted at lines 39 and 40 of NWE's

Additional Issues Testimony Exhibits TEM-3 and TEM-4, pertains to the assumed carbon-justified cost loadings that are embedded in these two new exhibits and in the resulting comparisons that are reported in the Additional Issues Testimony. These loadings begin in 2021 (see line 39 of TEM-3 and TEM-4) and are also reflected in the NPVs at line 38 and in the levelized market prices at line 40. These are the calculated market values that NWE uses in its Additional Issues Testimony for comparison with its extreme capital expenditure ranges in its new capex sensitivity analyses.

**Q. HAVE YOU PREVIOUSLY PROPOSED WAYS FOR DEALING WITH PROJECTED BUT UNCERTAIN MARKET PRICE ALTERNATIVES?**

**A.** Yes. Earlier, in response to PSC-202, I suggested a potential ratemaking compromise regarding these estimated but uncertain values that is similar to the Commission's practices for dealing with deferred income taxes[1]. Under this compromise, the purchase price of the hydros would be included in the Company's rate base immediately, and NWE would receive the full amount of associated revenues (just as it receives revenues associated with deferred taxes). The portion of revenues justified by assumed carbon costs would be recognized as consumer contributed capital until actual carbon

[1] Deferred income taxes are paid to the Company by ratepayers long before NWE actually pays taxes to the government – as would also be the case with carbon-justified revenues.

costs (whether the result of carbon taxes, cap and trade markets or other means) are enacted, at which time an appropriate part of the accumulated deferral (as reflected by actual carbon costs) would reverse and accumulated revenues would be counted as Company profit.[2]

**Q. ARE THERE ALTERNATIVE AND PERHAPS MORE EASY-TO - IMPLEMENT APPROACHES TO ACHIEVING SUCH A COMPROMISE?**

**A.** The alternative approach described in footnote 2 would be a reasonable option that could, together with the symmetrical incentive range for future capital expenditures as suggested by NWE's capex sensitivity analyses, pave the way to hydro acquisition approval at the purchase price together with reasonable consumer protection.

**Q. HOW COULD SUCH A PROCEDURE BE IMPLEMENTED?**

A. Under this compromise procedure the full purchase cost of the hydros would be included in NWE's rate base and the Company would collect its

[2] Recently, another alternative compromise on these related cost matters, that could possibly resolve this case in favor of the hydros acquisition at the requested rate base level that NWE is seeking in this proceeding was posed as a question in a *Great Falls Tribune* editorial:

> We wonder, for example, whether the Public Service Commission could approve the deal but also lay down a time period in which the carbon issue would need to be resolved. If a carbon tax did not happen by 2021, for example, the PSC could order NorthWestern to rebate carbon tax overcharges to customers.

full associated revenue requirement. Carbon-justified revenues would be accounted for in a refundable revenue account without rate base deduction and the Commission would establish a time frame for refunding these revenues to consumers if corresponding carbon costs are not implemented. This would make carbon-justified revenues an interest free loan to the Company until refunds (if any) are made. If refunds are not required the funds would be unrestricted Company revenue.

**Q. WHAT TIME FRAME SHOULD BE ESTABLISHED FOR ANY REFUND OBLIGATION?**

**A.** While that would be a matter of Commission discretion, in my opinion the appropriate time to require any refunds if carbon costs are not implemented would be 2021, when NWE's assumed carbon-justified costs boost market prices in the Company's revenue requirements model. At that time, if NWE's assumed carbon costs have not been implemented, refunds of already collected carbon-justified revenues would start to be made and no further carbon loadings would be reflected in future revenue requirements unless carbon costs are implemented at a later date.

**Q. IN YOUR OPINION, CAN THIS COMPROMISE ON THE LOADING OF CARBON COSTS INTO NWE's RATES, TOGETHER WITH THE ESTABLISHMENT OF A SYSTEM OF SYMMETRICAL CAPITAL EXPENDITURE INCENTIVES REFLECTING THE "EXTREME" CAPITAL EXPENDITURE RANGE IDENTIFIED BY THE COMPANY IN ITS ADDITIONAL ISSUES TESTIMONY, PROVIDE A REASONABLE RATEMAKING BASIS FOR APPROVING THE HYDROS ACQUISITION AS PROPOSED BY NWE IN THIS CASE?**

A. Yes. A combination of the carbon cost treatment described above, together with the future capital expenditure range identified by NWE in its Additional Issues testimony, could establish a satisfactory ratemaking basis for that approval.

**Q. HAVE YOU REVIEWED THE ADDITIONAL ISSUES TESTIMONY THAT HAS BEEN SUBMITTED BY COMPANY WITNESS STIMATZ?**

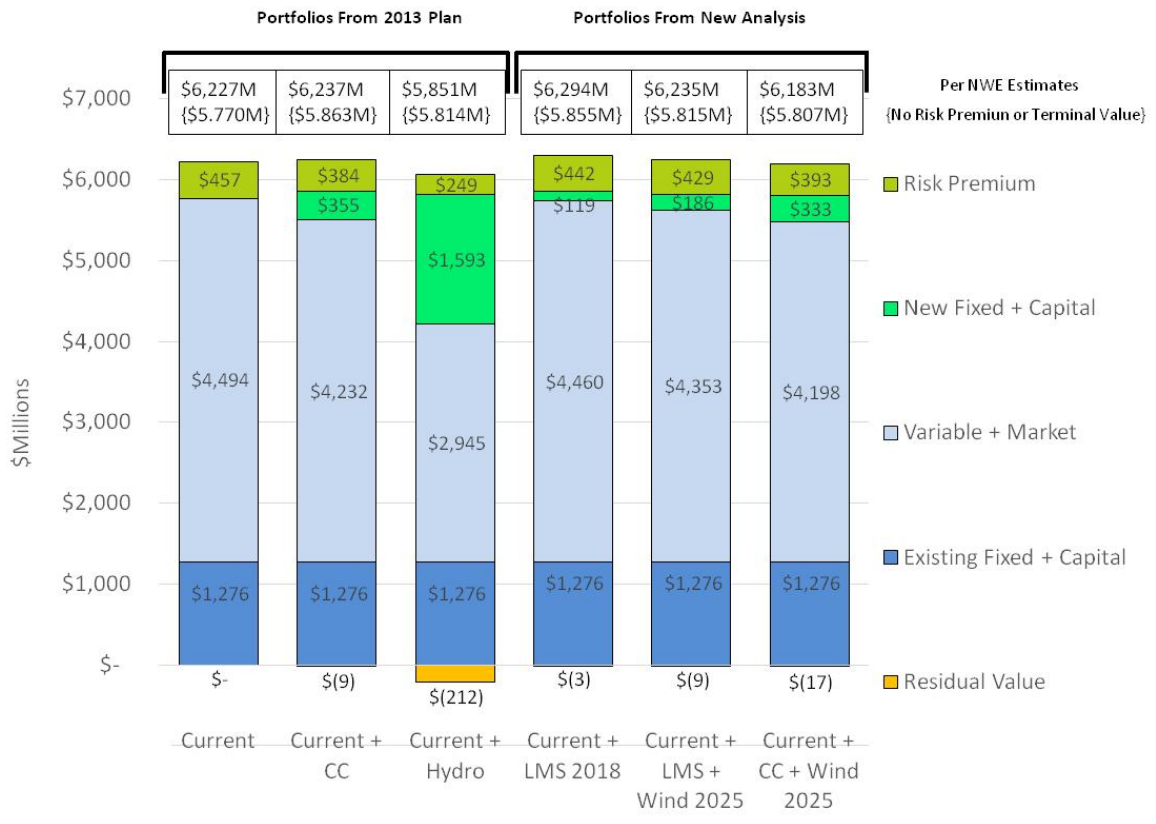
A. Yes; I have.

**Q. AT JMS-3 MR. STIMATZ PRESENTS A TABLE WHICH HE SAYS SHOWS THAT ON A RISK-ADJUSTED NPV BASIS, ADDING THE HYDROS TO THE COMPANY'S CURRENT PORTFOLIO OF GENERATION ASSETS WILL BE ABOUT $332 MILLION LESS COSTLY THAN THE NEXT BEST ALTERNATIVE. DO YOU AGREE WITH THAT CONCLUSION?**

A. No.

**Q. PLEASE EXPLAIN WHY YOU DO NOT AGREE WITH THIS CONCLUSION.**

A. Mr. Stimatz's Additional Issues argument closely parallels the argument that he made in his direct testimony. While the Company's hydro acquisition proposal can be appreciated on a number of grounds (and, in my opinion, can be reasonably approved with the compromises discussed above), Mr. Stimatz's financial comparison argument is not an accurate reflection of the relative financial merits of the various alternatives. The chart below reflects Mr. Stimatz's table at JMS-3, showing the cost components of the various portfolios.




As this presentation of the Company's NPV cost forecasts shows, the hydro's advantage is attributable to (1) an assumed resale market value of the plants in 30 years ($1.68 billion in current dollars or $212 million NPV) and (2) a high market purchase risk premium that is added to the non-hydros options (e.g., $457 million that is added to the market purchase or "current" alternative). Without these two adjustments, the NPV of the hydros option (using the Company's carbon loaded model) would be $5,814 million and the NPV for the "current" option would be $5,770

million.[3] The costs of the other options would also be very close to or less than the hydros.

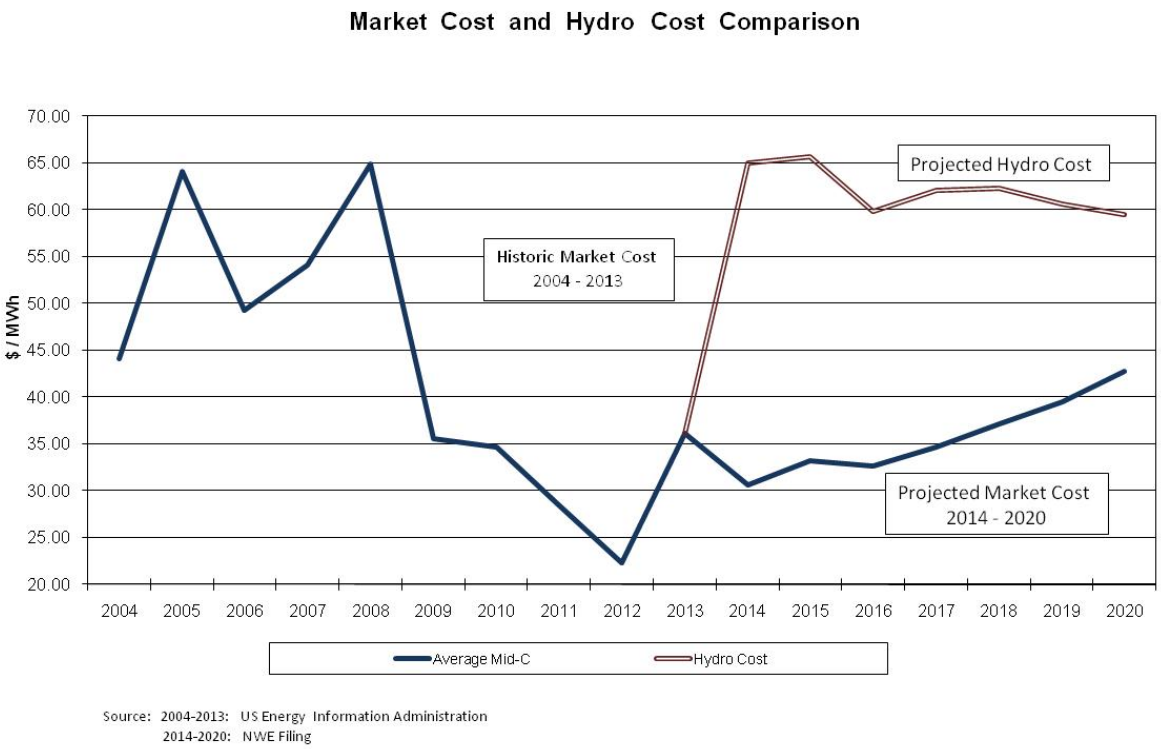
**Q. ARE YOU CONTENDING THAT THERE IS NO RISK THAT SHOULD BE CONSIDERED WITH RESPECT TO PROJECTED FUTURE MARKET PRICES?**

A. No; certainly not. While the market price projections out to 2020 in NWE's model reflect actual futures market prices that can be locked in without substantial risk, projections beyond 2020 may be higher or lower than what actually occurs in future markets. So, there is long term future market price risk. But, as I discussed in my direct testimony, there is also future risk associated with currently unknown and unanticipated potential future capital expenditure levels to repair and maintain the hydro plants into the distant future, and the cost associated with this risk is not included in the Company's stochastic modeling. Mr. Stimatz's cost comparisons in the table at JMS-3 in his Additional Issues Testimony are therefore biased by including a large risk premium for market purchases but none for currently unknown hydros capital expenditures that may be required in the future.

Moreover, market price risks in Northwest markets have declined substantially in the last five or six years as natural gas production in

[3] The "current" option cost is also greatly inflated by NWE's assumed carbon tax loading, which I have set aside for the purpose of this discussion.

Montana and throughout the United States has experienced major change. Because of this change and the large increase in low cost natural gas production, the market cost of electricity has declined substantially and has become relatively stable at much lower levels than those experienced in the years running up to 2008 when the ratebasing of CU4 occurred. As the chart below shows, the average annual cost of electric market purchases rose steeply and remained high and volatile in the $45 to $65 range (per Mwh) from 2004 through 2008. However, the market price then dropped precipitously in 2009 to $35 and has remained in the $23 to $35 range from 2009 through 2013, and futures prices are in the $30 to $40 range out to 2020. To assume that electric market prices in the foreseeable future will return to the levels and volatility that was experienced in the 2004-2008 period would be a mistake that ignores the substantial gas supply change that has occurred in Montana, the Northwest and throughout North America since that time, and the impact that this change has had on electricity market prices.




Source: 2004-2013: US Energy Information Administration
2014-2020: NWE Filing

**Q. DOES THIS CHART DEMONSTRATE THAT APPROVAL OF THE HYDROS ACQUISITION WILL BE EXCESSIVELY COSTLY FOR MONTANA RATEPAYERS?**

A. While there is no doubt that approval of the ratemaking treatment that NWE requested in its filing for the hydros would be far more costly than market purchase costs at least out to 2020, the Company forecasts that with large carbon cost loadings to the market purchase alternative from 2021 forward (and with limited future capital expenditure requirements for the hydros), future market costs could become substantially higher over the next three decades, and then the hydros would be no more costly over the

long term.

That potential future benefit may or may not be realized. Accordingly, the compromises discussed above (a symmetrical incentive range for future capital expenditures and either deferred recognition of carbon-justified profits or potential refund obligations for carbon-justified revenues if carbon costs are not implemented) would provide ratepayers with price protections warranting approval of the hydros purchase.

**Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY ON ADDITIONAL ISSUES?**

A. Yes; it does.