

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

IN THE MATTER OF the Lost Revenue) REGULATORY DIVISION
Adjustment Mechanism of NorthWestern) DOCKET NO. D2014.6.53
Energy) ORDER NO. 7375a

FINAL ORDER

BACKGROUND

1. On June 7, 2004, NorthWestern Corporation, doing business as NorthWestern Energy (NorthWestern or NWE), first proposed to recover “lost transmission and distribution revenues.” *See* Order 6496f, Dkt. D2003.6.77, ¶¶ 66-67 (Dec. 15, 2005). NorthWestern argued in part that without regular rate adjustments to recover lost transmission and distribution (T&D) revenues, it would “lose money between rate cases.” *Id.* The Montana Consumer Counsel (MCC) opposed lost revenue adjustments, arguing that “utilities are not entitled to all increased revenues that could occur between rate cases.” *Id.* ¶ 149.

2. On December 15, 2005, the Public Service Commission (Commission or PSC) acknowledged, “There are costs related to addressing the lost revenue disincentive,” but found:

[T]he 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. Additionally, NWE is in the midst of planning for the acquisition of significant supply resources to replace existing supply contracts that expire in 2007. In light of the widely acknowledged disincentive tied to lost T&D revenue, the public interest value of [demand-side management], 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.

Id. ¶ 156 (estimating \$273,196 for electric T&D lost revenues in 2004-2005); *see also* Order 6682d, Dkt. D2005.5.88, ¶ 73 (July 11, 2006) (estimating \$920,249 for electric T&D lost revenues in 2005-2006). On March 6, 2007, “consistent with the PSC determination and

findings in NWE's electric trackers," the Commission approved the same lost revenue adjustment mechanism (LRAM) for gas T&D assets. Order 6741c, Dkt. D2006.5.58, ¶¶ 51-52 (Mar. 6, 2007) (estimating \$491,254 for gas T&D lost revenues in 2006-2007). The LRAM required NorthWestern to true-up lost T&D revenues based on a comprehensive program evaluation and independent verification of actual savings. *See id.* ¶ 50.

3. Filed on August 16, 2007, the first comprehensive evaluation found that NorthWestern had actually saved less electricity and gas and thus lost less revenue than previously estimated. Order 6836c, Dkt. D2007.5.46, ¶¶ 59, 63 (June 3, 2008) (estimating \$2,890,656 for electric T&D lost revenues in 2007-2008). The Commission found that the existing LRAM should continue given "inadequate information on the relative merits of decoupling." *Id.* ¶¶ 181-182 (directing NorthWestern "to discontinue the practice of projecting lost revenues."); *see also* Order 6832c, Dkt. D2007.5.44, ¶¶ 19, 22 (Jan. 15, 2008) (finding no contested issues "within the scope of this docket"); Order 6930d, Dkt. D2008.5.44, ¶ 21 (Feb. 10, 2009) (estimating \$641,803 for gas T&D lost revenues in 2007-2008).

4. On May 29, 2009, NorthWestern sought an additional \$166,041 for lost revenues associated with Colstrip Unit 4 (CU4) in 2008-2009. Order 6921c, Dkt. D2008.5.45, ¶¶ 68, 80 (Apr. 27, 2010) (estimating \$577,988 for CU4 lost revenues in 2009-2010); *see also* Order 6925f, Dkt. D2008.6.69, ¶¶ 236, 248 (Nov. 13, 2008) (allowing \$407,000,000 in rate base for CU4). The MCC opposed this request, and the Commission ultimately approved a stipulation wherein the parties agreed that NorthWestern would collect one-half of its initial request for CU4-related lost revenues, or \$83,021. Order 6921c ¶ 88. The Commission observed, "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." *Id.* ¶ 87.

5. For the next several years, the Commission continued to allow NorthWestern to collect lost revenues associated with T&D assets and CU4. *See* Order 7004c, D2009.5.63, ¶ 21 (Dec. 21, 2010) (approving gas supply costs); Order 7093c, Dkt. D2010.5.50, ¶ 24 (Apr. 15, 2011) (estimating \$3,555,817 for electric lost revenues in 2009-2010); Order 7152b, Dkt. D2011.5.36, ¶ 11 (Apr. 10, 2012) (approving gas supply costs); Order 7218b, Dkt. D2012.5.48 (May 21, 2013) (approving gas supply costs).

6. Beginning April 2012, the Commission allowed recovery of lost revenues associated with the Dave Gates Generating Station (DGGS). Order 7154b, Dkt. D2011.5.38,

¶¶ 19, 33 (Apr. 10, 2012) (allowing NorthWestern to resume the practice of forecasting lost revenues); *see also* Order 6943e, Dkt. D2008.8.95 ¶ 81 (Mar. 20, 2012) (allowing \$182,537,625 in rate base for DGGS).

7. Filed on January 18, 2013, NorthWestern's second evaluation of demand-side management (DSM) program savings again found that it had saved less energy and thus lost less revenue than previously estimated. *See* Order 7219h, Dkt. D2012.5.49, ¶ 42 (Oct. 17, 2013).

8. On October 17, 2013, the Commission finalized approval of lost revenues actually incurred from July 2006 through June 2011, but made several adjustments because it found: "In certain instances, NorthWestern did not meet its burden of demonstrating through an independent, third-party program evaluation that its reported energy efficiency program savings . . . were actually realized." *Id.* ¶ 72. The Commission also recognized "that prior orders have established a precedent of full recovery of lost revenues associated with verified savings," but provided notice that it was "skeptical of the *status quo* regarding lost revenue recovery":

The Commission is troubled by the magnitude and complexity of the [second evaluation], and by the administrative cost associated with overseeing the process of determining realized savings. The Commission recognizes that NorthWestern's expectation of lost revenue recovery is embedded in its cost estimates in this case, as well as in Docket D2013.5.33. The Commission observes that the policy of allowing lost revenue recovery for [universal system benefits] programs appears particularly questionable given that such programs are required by law.

Regarding lost revenues associated with electric supply DSM program savings, the Commission observes that frequent rate cases will largely mitigate the impact of lost revenues due to energy efficiency programs on NorthWestern's usage-dependent recovery of capital asset costs. . . .

Order 7219h ¶¶ 78-79, 118 (as amended by Order 7219i, Dkt. D2012.5.49, ¶ 15 (May 13, 2014)).

9. On December 20, 2013, NorthWestern challenged the Commission's lost revenue adjustments, alleging that the Commission rejected expert opinion without evidence or party advocacy to the contrary. *Pet. for Judicial Rev. 8-9, NorthWestern Corp. v. Mont. Dep't of Pub. Serv. Regulation* (2d Mont. Dist. Ct. 2013) (Cause No. DV-13-399). NorthWestern filed its *Opening Brief* on June 13, 2014; the Commission, the Human Resources Council District XI and Natural Resources Defense Council (HRC/NRDC), and the MCC filed response briefs in early August; NorthWestern filed a *Reply Brief* on September 5, 2014; and the District Court heard oral arguments on October 1, 2014. On August 11, 2015, the District Court issued an *Order Affirming Decision of Montana Public Service Commission* with respect to the lost revenue

adjustments. On October 9, 2015, NorthWestern filed a *Notice of Appeal* with the Montana Supreme Court concerning the District Court's decision to affirm the Commission.

PROCEDURAL HISTORY

10. On June 16, 2014, the Commission initiated this contested case proceeding to address the recovery of lost revenues by NorthWestern. The MCC, HRC/NRDC, and NorthWestern are parties to this proceeding.

11. On December 19, 2014, HRC/NRDC filed the *Direct Testimony of Thomas Michael Power* (HRC-1); the MCC filed the *Direct Testimony of John W. Wilson* (MCC-1); and NorthWestern filed the *Direct Testimony of Patrick R. Corcoran* (NWE-5) and *Brian B. Bird* (NWE-1).

12. On January 30, 2015, NorthWestern responded to Data Requests MCC-001 through MCC-005 and PSC-001 through PSC-024; HRC/NRDC responded to PSC-025 through PSC-053; and MCC responded to PSC-054 through PSC-074.

13. On March 25, 2015, HRC/NRDC filed the *Response Testimony of Thomas Michael Power* (HRC-2); the MCC filed the *Response Testimony of John W. Wilson* (MCC-2); and NorthWestern filed the *Response Testimony of Ric Gale* (NWE-3).

14. On April 1, 2015, the Commission identified the following additional issues: (1) Whether LRAM should continue to apply to fixed-cost generation and production assets or be limited to T&D assets; (2) how LRAM, if it is retained, should be modified; and (3) what guidance the Commission should give, if any, on NorthWestern's forthcoming decoupling filing.

15. In mid-April, NorthWestern responded to Data Requests MCC-006 through MCC-010 and PSC-075 through PSC-077; HRC/NRDC responded to MCC-011 through MCC-012 and PSC-081 through PSC-082; and MCC responded to PSC-081 through PSC-082.

16. On April 30, 2015, HRC/NRDC filed the *Additional Issues Testimony of Thomas Michael Power* (HRC-3); the MCC filed the *Additional Issues Testimony John W. Wilson* (MCC-3); and NorthWestern filed the *Rebuttal Testimony of Ric Gale* (NWE-4) and the *Additional Issues Testimony of Patrick R. Corcoran* (NWE-6) and *Joe Schwartzenberger* (NWE-2).

17. On May 13, 2015, NorthWestern responded to Data Requests MCC-013 through MCC-020 and PSC-083 through PSC-093, and MCC responded to PSC-094.

18. The Commission issued a *Notice of Public Hearing* on May 8, 2015. The MCC filed a *Prehearing Memorandum* on May 29; HRC/NRDC and NorthWestern filed prehearing memoranda on June 1, 2015.

19. On June 9, 2015, the Commission conducted a public hearing. As requested during cross-examination, NorthWestern provided the following information on June 11, 2015: (1) Rate of return percentages for NorthWestern with and without LRAM as shown in NWE-1, pages 4-5 for 2014 (Updated NWE-1); and (2) rate of return percentages for DGGS with and without LRAM as shown in the Attachment provided in response to Data Request PSC-003d, but excluding the wholesale portion of DGGS (Revised PSC-003d).

20. The parties filed initial briefs on July 24, and response briefs on August 21, 2015.

FINDINGS OF FACT

21. To the extent that any statement above constitutes a finding of fact, it is hereby adopted as such.

22. In this case, all parties acknowledged that NorthWestern may face a throughput incentive because it recovers fixed costs through volumetric rates. (NWE-5 at 6; HRC-1 at 2; MCC-1 at 8). All parties also recognized that “the efficient use of energy and economically warranted conservation remain important public policy goals.” (MCC-1 at 6; *see* NWE-3 at 8; HRC-1 at 10-12). Although NorthWestern and HRC/NRDC generally support decoupling as an alternative to LRAM, all parties agreed that the Commission should not order or implement a decoupling mechanism in this proceeding. (NWE-5 at 25; NWE-6 at 14; HRC-1 at 27-28; MCC-2 at 5-6; MCC-3 at 9).

23. NorthWestern contended that the Commission is required to allow lost revenues in order to support the Company’s pursuit of DSM resources and provide a reasonable opportunity to earn its authorized rate of return. (NWE-5 at 20-21). It argued that absent the LRAM (or a similar mechanism), mandated DSM programs will impair its ability to recover its costs and opportunity to earn its authorized rate of return. (*Id.*; NWE-6 at 7-8; Hr’g Tr. 105:11–25). NorthWestern also asserted that discontinuing the LRAM would significantly impact its profitability and credit quality in the investor community and among ratings agencies. (NWE-1 at 3-8; Hr’g Tr. at 40-42). However, NorthWestern has had a preference for a revenue-based regulation or decoupling mechanism “for some time.” (NWE-5 at 25). It recommended

continuing to use the LRAM “until such time that NorthWestern can prepare and submit a filing to the Commission proposing the use of a Revenue-based Regulation of Decoupling mechanism.” (*Id.*; *see also* NWE-6 at 14; Hr’g Tr. 100:1-16).

24. HRC/NRDC asserted that the throughput disincentive caused by lost revenues is a real and widely recognized barrier to efficient DSM acquisition, which is part of a business-like, economics-based approach to achieving a least cost resource portfolio for customers. (HRC-1 at 2-7). HRC/NRDC recommended that the Commission order NorthWestern to prepare a decoupling proposal providing “sufficient time to prepare such a proposal,” and continue to use the LRAM in the meantime. (*Id.* at 27-28).

25. The MCC acknowledged the need to pursue cost-effective DSM resources and that NorthWestern may face a throughput disincentive to do so. (MCC-1 at 6-8). It contended, however, that the LRAM undermines the fundamental regulatory process of setting just and reasonable rates based on a balanced and matched consideration of all relevant costs, revenues, and loads within the same time period. (*Id.*; MCC-2 at 7). The MCC also asserted that “many changes occur between rate cases,” and that countervailing incentives adequately encourage NorthWestern to pursue cost-effective DSM as part of a least cost resource portfolio. (MCC-1 at 7-8, 12; MCC-2 at 6, 13). It urged the Commission to avoid piecemeal cost of service adjustments between general rate cases, and to terminate the LRAM. (MCC-3 at 6, 11, 15).

Initial Approval

26. The Commission initially approved the LRAM in order to enable NorthWestern to build a portfolio of demand-side resources; it was concerned that the throughput incentive would jeopardize NorthWestern’s “ramp-up” of efficiency programs “in the near-term.” Order 6496f ¶¶ 156-157 (citing “the demonstrated volatility of energy supplies” and NorthWestern “planning for the acquisition of significant supply resources”). The concern about DSM and lost revenues was heightened at a time when NorthWestern had acquired virtually no supply or demand-side resources, but was about to “assemble” an integrated default supply portfolio. *Id.* ¶ 154.

27. When the Commission initially implemented the LRAM, it did so with at least four reservations. First, it approved the recovery of T&D lost revenues on an interim basis, requiring a true-up based on actual program activity “following a comprehensive program

evaluation and independent verification of actual savings.” Order 6496f ¶¶ 157-161 (“NWE must consult with its advisory committee on the selection of an independent contractor”).

28. Second, “the Commission questioned whether default supply rates were the appropriate rates with which to recover lost T&D revenue,” and found that there “may be legal and/or policy reasons to use other than default supply rates to recover lost revenues, to the extent a lost revenue adjustment of some kind will continue.” *Id.*

29. Third, the Commission directed further study to justify the continuation of the mechanism:

NWE, in consultation with its advisory committee, must thoroughly evaluate the costs and benefits of the interim lost T&D revenue adjustment mechanism approved in this Order from Company, ratepayer and societal perspectives. . . . To the extent NWE wishes to continue the lost T&D revenue adjustment approach, the report must justify such a request in terms of the costs and benefits of that approach compared to other available methods for addressing the lost revenue disincentive, such as the various forms of decoupling, and a ‘do nothing’ approach. . . .

[T]he Commission intends to revisit this issue when NWE files its evaluation of the overall lost T&D revenue adjustment mechanism in June 2007.

Id.; see also Order 6682d ¶ 74 (“NWE needs to be aware that a request to continue the lost T&D revenue adjustment approach will need to justify such a request in terms of the costs and benefits of that approach”).

30. Fourth, the Commission agreed that a plausible argument had been made that “lost T&D revenues represent an opportunity cost” (before concluding that they were “an actual cost of providing default supply service”). Order 6496f ¶ 161, 6; *infra* ¶ 64.

Changed Circumstances

31. The Commission continues to acknowledge that a utility’s acquisition of cost-effective DSM mitigates upward pressure on long-term portfolio costs, and that volumetric rates may create a throughput incentive (and corresponding disincentive to pursue cost-effective energy efficiency). *Supra* ¶¶ 2, 22, 26. However, at least three circumstances have changed since the Commission first authorized the recovery of lost revenues.

32. First, NorthWestern now has a mature portfolio of DSM and energy efficiency programs, the actual costs of which it fully recovers through rates. See *e.g.* 7219h ¶¶ 41-42, 122 (verifying 270,564 megawatt-hours of total energy savings from July 2006 through June 2011).

33. Second, NorthWestern is now a vertically integrated utility that owns many more generation assets and natural gas reserves than it did when it “concluded that it was not appropriate for it to operate energy efficiency programs for its customers” following deregulation. (DR PSC-031a; *see also* Hr’g Tr. 23:2-8). Since the Commission last approved electric supply rates on a final basis, NorthWestern has begun collecting lost revenues associated with the fixed costs of its 40 megawatt (MW) Spion Kop Wind Project (Spion Kop) and 439 MW hydroelectric acquisition.¹ *See* Order 7159I, Dkt. D2011.5.41, ¶ 12 (Feb. 14, 2012) (projecting \$86,115,035 in rate base for Spion Kop); Order 7323k, Dkt. D2013.12.85, ¶ 186 (Sept. 25, 2014) (allowing \$870,000,000 in rate base for the hydroelectric acquisition). Since the Commission last approved its gas supply rates on a final basis, NorthWestern has begun collecting lost revenues associated with its Battle Creek gas production field (Battle Creek). Order 7210b, Dkt. D2012.3.25, ¶¶ 50, 85, 97 (Nov. 15, 2012) (allowing \$12,371,854 in rate base for Battle Creek). More recently, NorthWestern started collecting the fixed costs of its Bear Paw gas production assets on an interim basis. *See* Nov. 2012 Monthly Natural Gas Cost Rate Adjustment & Tariff Approval, Dkt. D2012.7.74 (Oct. 26, 2012); Dec. 2013 Monthly Natural Gas Cost Rate Adjustment & Tariff Approval, Dkt. D2013.7.54 (Nov. 22, 2013). The LRAM initially approved for T&D assets was never intended to account for so many fixed costs outside of a general rate case. *Supra* ¶¶ 1-4, 27-30.

34. Third, wholesale electricity and natural gas prices are generally lower and more stable today, reducing the cost-effectiveness threshold for efficiency programs. (MCC-1 at 5-6, 15). Although short-term market trends should not be the sole determinant of long-term DSM expenditures, the relative stability of market prices and maturity of NorthWestern’s DSM portfolio have mitigated the sense of urgency that initially justified the LRAM.

Policy Reexamination

35. The Commission has now reexamined its lost revenue policy and discontinues the LRAM for at least five additional reasons.

36. First, the Commission finds that the LRAM is not consistent with the matching principle, which promotes comprehensive regulatory oversight and alignment between utility

¹ Including Confederated Salish and Kootenai Dam (formerly Kerr Dam), which is no longer owned by NorthWestern, the nameplate capacity of the initial hydroelectric acquisition was 633 MW. *See* Order 7323k ¶ 24.

rates, costs, and sales volumes. (MCC-2 at 8-9, 24). “The matching principle means that revenues, expenses, operating assets, and customer loads are all appropriately matched within a period of time when rates are set (such as a regulatory test year for a general rate case).” (DR MCC-016). LRAM, meanwhile, is single-issue ratemaking that provides an increase in utility revenues, without regard to the universe of other factors that influence utility returns. The Commission remains committed to the principle of establishing just and reasonable rates through comprehensive review in rate cases, and agrees that this “important element of sound rate regulation is undermined by the current LRAM procedure.” (MCC-1 at 7). Such oversight is especially important for a vertically re-integrated utility like NorthWestern; with reduced exposure to wholesale commodity markets and increased investment on which it may earn a return, rate adjustments between rate cases should receive greater scrutiny. *Supra* ¶¶ 33-34. The LRAM is not in the public interest to the extent that it obstructs comprehensive realignment of NorthWestern’s revenues, costs, and rates.

37. Second, the inherent uncertainty of DSM savings estimates and the accumulation of lost revenues based on such estimates since the last rate case make it increasingly difficult to confirm that rates are just and reasonable. Unlike a decision to build or purchase a power plant, energy efficiency efforts require action by both the utility and its customers. By extension, the LRAM requires empirically establishing the savings attributable only to utility programs. (DR PSC-079a). These estimates of efficiency savings are highly uncertain and contentious, requiring an “extensive review and analysis of the amount and value of savings. . . . lead[ing] to more significant disputes in the rate-setting process.” (NWE-5 Ex. 2 at 87-88). As demonstrated by the last attempt to true-up lost revenues based on a comprehensive program evaluation, discerning whether the utility or customers are driving particular energy efficiency gains is not a simple analytical task.² *Supra* ¶¶ 8-9. Experience implementing the LRAM has revealed that such a complex policy is not workable given the mediocre evidentiary foundations of its quantification.

² In that Docket, NorthWestern’s position was that the question was essentially unanswerable, to the point of requiring the Commission to assume that DSM freeridership and spillover are perfectly offsetting forces. Order 7219h ¶ 53 (As the company’s witness argued, “[I]n the absence of any other information, you just assume that one is positive and one is a negative; they’re offsetting”). Ultimately, the Commission gave greater weight to the empirical results of NorthWestern-sponsored surveys, which found that freeridership justified a reduction to claimed savings. *Id.* ¶¶ 54-59.

38. Third, NorthWestern and its customers will continue to acquire cost-effective efficiency resources with or without the LRAM. (Hr’g Tr. 95:12-20; *see also* DR MCC-018a). Certain regulatory expectations, societal aversion to energy waste, and public relations interests create real incentives to pursue cost-effective energy savings, even without the LRAM. (MCC-1 at 8-9, 20-24; MCC-2 at 18-22; HRC-1 at 6). With respect to regulatory requirements and expectations, the existing planning and prudence review processes provide regulatory oversight with respect to NorthWestern’s acquisition of DSM resources.³ (MCC-1 at 9). “Simply put, there is no empirical evidence from which to assert that removing the income effect of regulatory lag between rate cases is necessary in order to maintain the incentives that NorthWestern has to support economic energy conservation.” (MCC-2 at 23). Although energy efficiency opportunities have become increasingly commonplace, the LRAM has only adjusted rates upward, dampening the financial reward to customers who have participated in DSM programs (compared to a situation in which those consumers had undertaken the same actions themselves). The Commission agrees that “additional compensation” should not be required to maintain NorthWestern’s satisfactory pursuit of DSM resources. (Hr’g Tr. 142:21-25).

39. Fourth, a plausible argument continues to exist that lost revenues are “opportunity costs,” unlike the direct program costs that are invoiced and paid out for labor, light bulbs, advertising, and other products and services. (NWE-5 at 18; NWE-6 at 10-11; DR PSC-084; MCC-1 at 11); *see also* Order 6496f ¶ 161 (“from the Company’s perspective lost T&D revenues represent an opportunity cost”). Generally, an opportunity cost is “[t]he cost of acquiring an asset measured by the value of an alternative investment that is foregone.” *Black’s Law Dictionary* 295 (Bryan A. Garner ed., 8th ed. 2005). NorthWestern would like to recover the value of foregone sales volumes through rates, which only begin to accumulate after rate cases. Unlike the direct expenses and investments that NorthWestern makes for DSM and efficiency programs, however, lost revenues are an indirect, secondary effect of the rate structure.

40. Fifth, the LRAM does not eliminate the throughput incentive. Because LRAM only adjusts rates to account for volumes of energy saved, it only mitigates the throughput incentive with respect to those volumes, and even then, only if the savings are measured

³ For example, unlike most advertising expenses, “advertising that encourages the conservation of energy” may be included in rates. Mont. Code Ann. § 69-3-307 (2015); *see also* § 69-8-210(1) (allowing the actual costs of DSM and energy efficiency programs in rates).

accurately. The LRAM may actually create a perverse incentive to maximize both the estimates of savings attributable to utility efforts and actual sales volumes, because both reward the utility with revenues. (HRC-1 at 17-18; DR PSC-015a; DR-PSC-077a). Although the LRAM was intended to mitigate the throughput incentive, it does so only in a limited way, and only if certain assumptions are accurate.

41. The significance of these concerns has increased in tandem with the size of LRAM adjustments. Lost revenues have been accumulating for T&D assets since interim rates were granted in rate cases. Interim Order 7046g, D2009.9.129, ¶ 28 (July 8, 2010) (approving interim electric rates); Interim Order 7249d, Dkt. D2012.9.94, ¶ 31 (Mar. 19, 2013) (approving interim gas rates). Meanwhile, the size of electric adjustments has ballooned from \$231,273 to \$10,058,433 per year. (DR MCC-001b). Lost revenues are estimated to be \$12,665,362 for 2014-2015, not including those that have begun to accumulate for the hydroelectric acquisition. (HRC-1 at 10). And as of December 2014, cumulative electric and gas lost revenues totaled \$37,838,229. (NWE-5 at 8). The LRAM was never intended to encompass so many fixed costs, and the larger magnitude of lost revenues at stake makes the verification of savings even more contentious. (DR PSC-029). Also, LRAM increases an existing tendency for utilities to over-recover revenue requirements for generation and production assets. (MCC-1 at 9-10; MCC-3 at 3; Hr'g Tr. 144:17-21). Discontinuation of the LRAM will simplify the calculation of rates and improve the Commission's ability to ensure just and reasonable rates.

Just and Reasonable Standard

42. With respect to fixed cost recovery, the Commission finds that lost revenue adjustments were never intended to be a primary determinant of a utility's ability to earn a reasonable rate of return over time. As in the business world, level or even reduced revenues do not necessarily translate into lower profits for NorthWestern. Efficient, forward-looking companies change their business models to get out in front of consumer trends, and in some cases, to realize greater profitability with less total revenue. In fact, the LRAM has never been the determinative factor in NorthWestern earning its authorized returns. (Updated NWE-1; Revised PSC-003d). As NorthWestern's own witness testified:

Whether or not a utility is able to achieve the authorized rate of return is a function of many independent factors between general rate filings including customers' usage levels influenced by weather, customer-specific behaviors and preferences

causing load growth or decline, an increasing or decreasing number of actual customers, utility cost increases or decreases, general economic conditions, and the level of investment in or retirement of utility assets.

(NWE-6 at 7-8; *see also* MCC-1 at 7-8, 12; MCC-2 at 6, 13).

43. NorthWestern's own experts disagreed about the impact of lost revenue adjustments (or the lack thereof) on the timing of rate cases. (Hr'g Tr. 59:12-60:22, 88:8-17). NorthWestern was not denied a reasonable opportunity to earn its authorized rate of return prior to implementation of the LRAM, and it will not be denied a reasonable opportunity to earn its authorized rate of return once the LRAM is discontinued. The traditional ratemaking process can protect NorthWestern's ability to earn authorized returns over time. *Infra* ¶¶ 54-59.

44. For the reasons discussed in this *Final Order*, the Commission changes its lost revenue policy for NorthWestern, and finds that discontinuation of the LRAM is necessary to ensure just and reasonable electric and gas rates.

Decoupling

45. Decoupling uses a surcharge or rebate to true up or "make up the difference" between the amount of revenue allowed in a rate case and the amount actually recovered. (NWE-5 Ex. 2 at 87). This allows a utility to recover the Commission-approved cost of providing service, regardless of whether its actual expenses and sales volumes are higher or lower than the test period. In other words, it matches revenues to the previously approved cost of providing service to a customer. Because actual revenues are trued up through either a surcharge or a refund, decoupling is more symmetrical than LRAM, which only results in surcharges. (Hr'g Tr. 58:23-59:19).

46. The Commission does not reject or endorse decoupling in this *Final Order*, because despite multiple opportunities to do so, NorthWestern did not propose decoupling or any other alternative in this proceeding. Over a year ago, the Commission directed parties to address the existence of the throughput incentive and "what mechanism or policy may be appropriate for mitigating or otherwise addressing the throughput incentive." Order 7375, Dkt. D2014.6.53, ¶ 3, (Oct. 23, 2014). Over nine months ago, the Commission asked the parties why it should "evaluate decoupling proposals in a future docket rather than the current docket," and issued numerous data requests about decoupling. (DRs PSC-002, PSC-026; *see also* DRs PSC-014 through PSC-022; DR PSC-024). Over six months ago, the Commission requested testimony

addressing several issues concerning decoupling “in order to simplify and expedite” future proceedings. *Notice of Additional Issues*, Dkt. D2014.6.53 (Apr. 1, 2015). The Commission cannot retain LRAM merely because the party in the best position to do so has failed to offer an alternative. If NorthWestern does choose to file a decoupling proposal, it must include in that proposal testimony and information that addresses those issues raised in the Commission’s *Notice of Additional Issues* in this Docket, among any other issues it chooses to identify.

CONCLUSIONS OF LAW

47. The Commission has full power of supervision, regulation, and control of public utilities, and has “power to prescribe rules of procedure and to do all things necessary and convenient in the exercise of the powers conferred.” Mont. Code Ann. §§ 69-3-102, 69-3-103 (2015). NorthWestern is a “public utility” subject to regulation by the Commission. *Id.* § 69-3-101.

48. The Commission “differs from other administrative agencies of our state government in that it is a department of our government created by the legislature, whose officials are elected to carry out and promote a legislative function.” *Cascade Cnty. Consumers Ass’n v. Pub. Serv. Comm’n*, 144 Mont. 169, 191-192, 394 P.2d 856 (1964) (“the acts of this agency are legislative and not judicial.”).

49. This *Final Order* “conform[s] to the requirements of a decision in a contested case under the Montana Administrative Procedure Act.” Mont. Code Ann. § 69-3-303. The Commission has afforded all interested parties an opportunity to respond and present evidence on all issues involved in this proceeding. *Id.* § 2-4-612(1); *supra* ¶¶ 8-20. Conclusions of law are reviewed to “determine whether the agency’s interpretation and application of law are correct.” *Klingman v. Mont. Pub. Serv. Comm’n*, 2012 MT 32, ¶ 25, 364 Mont. 128.

Ratemaking

50. Public utilities are “required to furnish reasonably adequate service and facilities” at rates that are “reasonable and just.” Mont. Code Ann. § 69-3-201 (“every unjust and unreasonable charge is prohibited and declared unlawful.”). “The Commission may include in a public utility’s rates . . . the cost-effective expenditures for improving the efficiency with which the public utility provides and its customers use utility services.” *Id.* § 69-3-1206.

51. “[I]t was the intention of the legislature to clothe the Commission with the power to fix the precise rate to be charged by the Utility for its commodity.” *Great N. Utils. Co. v. Pub. Serv. Comm’n*, 88 Mont. 180, 218, 293 P. 294, 303 (1930). What constitutes ‘just and reasonable’ rates depends upon the facts in each case: “A rate altogether just and reasonable in one instance may be most unjust and unreasonable in another.” *Id.* at 203, 293 P. at 298.

According to the Montana Supreme Court:

Rate structuring involves highly specialized theories of economics. The weighing and balancing of expert opinion pro and con is properly vested in the administrative agency in its field of expertise. . . .

[A] new rate structure should not be reversed merely because it is not perfect, especially where it is a considerable improvement over the old structure.

State of Mont. ex rel. Dept. of Pub. Serv. Regulation v. Mont. Irrigators, Inc., 209 Mont. 375, 381-382, 680 P.2d 963, 966-967 (1984).

52. The Commission may “investigate any of the rates, tolls, charges, rules, practices, and services and after a full hearing . . . make by order such changes as may be just and reasonable, the same as if a formal complaint had been made.” Mont. Code Ann. § 69-3-324. “If, upon such hearing and due investigation, the rates, tolls, charges, schedules, or joint rates are found to be unjust, unreasonable, or unjustly discriminatory or to be preferential . . . [it] may fix and order substituted therefor such rates, tolls, charges, or schedules as are just and reasonable.” *Id.* § 69-3-330.

53. The Commission may utilize its “experience, technical competence, and specialized knowledge in the evaluation of evidence.” *Id.* § 2-4-612(7).

Just Compensation

54. “[T]he Constitution protects utilities from being limited to a charge for their property serving the public which is so ‘unjust’ as to be confiscatory.” *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307, 109 S. Ct. 609, 615 (1989). However, not “all of the subsidiary aspects of valuation for ratemaking purposes [can] properly be characterized as having a constitutional dimension, despite the fact that they might affect property rights to some degree.” *Id.* at 310, 109 S. Ct. at 617 (“If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry . . . is at an end.”). Only if rates fail “to compensate justly for all of [the utility’s] private property dedicated to public use can [it] complain of a violation of

its fifth amendment rights.” *Mountain Water Co. v. Mont. Dept. of Pub. Serv. Regulation*, 919 F.2d 593, 600 (9th Cir. 1990).

55. “[R]ates must be set at a level that permits the company to earn a fair rate of return on its investment,” but “regulation does not guarantee that a utility will achieve its projected revenues.” *Potomac Elec. Power Co. v. Pub. Serv. Comm’n*, 380 A.2d 126, 131 (D.C. Cir. 1977). Public utility rates must provide “a reasonable opportunity to earn a rate of return sufficient to maintain the company’s financial integrity, to attract necessary capital at a reasonable cost, and to compensate investors fairly for the risks they have assumed, while protecting the relevant public interests.” *Id.* at 132 (“This involves a delicate balancing of investor and consumer interests.”).

56. If a utility’s electric and gas rates are not sufficient to maintain its financial integrity, attract capital at a reasonable cost, or compensate investors fairly, its “recourse as a utility to obtain just compensation . . . is to seek rate increases before the PSC.” *Mountain Water*, 919 F.2d at 600. In Montana, a public utility may include conservation purchases or investments in rate base, and the Commission may establish a rate of return on such investments that allows “up to 2% added to the rate of return on common equity permitted on the utility’s other investments.” Mont. Code Ann. § 69-3-712 (“for a period not to exceed 30 years”).

57. “In Montana, public utility rates are set to match utility costs during the period that rates are in effect.” *Mountain Water Co. v. Mont. Dept. of Pub. Serv. Regulation*, 254 Mont. 76, 79, 835 P.2d 4 (1992) (“Ratemaking is a legislative activity and is therefore prospective only in its effect.”). To support traditional rate increases, a utility must provide “a statement comparing sales and services and the revenues therefrom. . . . for the 12 months of [a] test period.” Mont. Admin. R. 38.5.103 (2015); *see A. Finkl & Sons*, 250 Ill. App. 3d at 325, 620 N.E.2d at 1147 (“The test year so selected [by the utility] is intended to be representative of both the utility’s anticipated rate-base expenses and its expected revenues, including overall costs and rate of return in the same year.”).

58. About a year before NorthWestern initially proposed the LRAM, the Commission adopted *Default Electric Supplier Procurement Guidelines* which provided: “A utility’s development of demand-side resources should include an examination of innovative methods to address cost recovery issues related to demand-side resource investments and expenses, including undesirable effects on revenues related to the provision of transmission and

distribution services.” 7 Mont. Admin. Reg. 654 (Apr. 10, 2003); Mont. Admin. R. 38.5.8218. The Commission anticipates ongoing examination of cost recovery issues, including decoupling, in NorthWestern’s next resource procurement plan and future filings. (DR PSC-086); *supra* ¶¶ 45-46.

59. Even without the LRAM, electric and gas rates afford NorthWestern a reasonable opportunity to recover and earn a fair rate of return on its investments; it is not confiscatory to discontinue the practice of adjusting rates between rate cases to account for lost revenues. *See supra* ¶¶ 26-44.

Supply Costs

60. For a public utility whose service territory “lies [partly] within the basin of the Columbia River,” the Commission “shall establish an electricity cost recovery mechanism that allows [it] to fully recover prudently incurred electricity supply costs, subject to the provisions of 69-8-419, 69-8-420, and [C]ommission rules.” Mont. Code Ann. §§ 69-8-201(4)(a), 69-8-210(1). By statute, “electricity supply costs” are defined as:

the actual costs incurred in providing electricity supply service through power purchase agreements, [DSM], and energy efficiency programs, including but not limited to: (a) capacity costs; (b) energy costs; (c) fuel costs; (d) ancillary service costs; (e) transmission costs, including congestion and losses; (f) planning and administrative costs; and (g) any other costs directly related to the purchase of electricity and the management and provision of power purchase agreements.

Id. § 69-8-103(8).

61. The Commission has previously concluded that Lost Revenues are an “energy efficiency cost” and “actual cost of providing default supply service.” *See* Orders 6496f, 6682d, 6741c, 6836c, & 6921c. In October 2013, however, the Commission gave notice that it might change this interpretation: “Although the Commission has concluded in past orders that lost revenues that reflect ‘actual costs’ are ‘electricity supply costs,’ it will revisit and may reassess this conclusion in future proceedings.” Order 7219h ¶ 78.

62. Today, the Commission has express authority to “include other utility costs and expenses in the [electric supply] cost recovery mechanism if it determines that including additional costs and expenses is reasonable and in the public interest.” *Id.* § 69-8-210(1). This was not true when it first allowed NorthWestern to recover lost revenues as “electricity supply costs.” *See* H.R. 25, 60th Reg. Sess. (Mont. 2007); Orders 6496f, 6682d, & 6741c.

63. “[A]n agency may ‘interpret’ a regulation without ‘effectively amend[ing] the underlying source of law.’” *Perez v. Mortgage Bankers Ass’n*, 135 S. Ct. 1199, 1208-1209 (2015) (“Congress is aware that agencies sometimes alter their views in ways that upset settled reliance interests.”). Agencies must provide “a reasoned explanation” for changing policy:

[T]he agency must show that there are good reasons for the new policy. But it need not demonstrate to a court’s satisfaction that the reasons for the new policy are better than the reasons for the old one; it suffices that the new policy is permissible under the statute, that there are good reasons for it, and that the agency believes it to be better, which the conscious change of course adequately indicates. This means that the agency need not always provide a more detailed justification than what would suffice for a new policy created on a blank slate. Sometimes it must – when, for example, its new policy rests upon factual findings that contradict those which underlay its prior policy; or when its prior policy has engendered serious reliance interests that must be taken into account. It would be arbitrary or capricious to ignore such matters. In such cases it is not that further justification is demanded by the mere fact of policy change; but that a reasoned explanation is needed for disregarding facts and circumstances that underlay or were engendered by the prior policy.

FCC v. Fox Television Stations, Inc., 556 U.S. 502, 515-516, 129 S. Ct. 1800, 1811 (2009) (internal citations omitted); *see also Am. Trucking Ass’n v. Atchison, Topeka & Santa Fe Ry. Co.*, 387 U.S. 397, 416, 87 S. Ct. 1608, 1618 (1967) (declaring that an agency, “in light of reconsideration of the relevant facts and its mandate, may alter its past interpretation and overturn past administrative rulings and practice.”); *Nat’l Ass’n of Home Builders v. EPA*, 682 F.3d 1032, 1037 (D.C. Cir. 2012) (“[a]n agency’s view of what is in the public interest may change, either with or without a change in circumstances.”); *Saint Fort v. Ashcroft*, 329 F.3d 191, 204 (1st Cir. 2003) (“Agencies do have leeway to change their interpretations of laws, as well as of their own regulations, provided they explain the reasons for such change and provided that those reasons meet the applicable standard of review.”).

64. In this proceeding, the Commission has reassessed its conclusion that lost revenues are “electricity supply costs.” *Supra* ¶ 39. The statute defining “electricity supply costs” makes no reference to lost revenues, opportunity costs, or foregone sales volumes. Mont. Code Ann. § 69-8-103(8). Instead, it plainly refers to “the *actual costs* of providing electricity supply service *through . . . [DSM] and energy efficiency programs*” and “other costs directly related to the purchase of electricity.” *Id.* (emphasis added). Other states have also distinguished lost revenues from the direct costs of utility programs and purchases. *See A. Finkl & Sons Co. v. Ill. Commerce Comm’n*, 250 Ill. App. 3d 317, 329, 620 N.E.2d 1141, 1149

(Ill. App. Ct. 1993) (“The lost revenue charge here does not reflect the cost of providing electric service”); *CenterPoint Energy Houston Elec., LLC v. Pub. Util Comm’n of Tex.*, 354 S.W.3d 899, 904 (Tex. App. 2011) (finding that legislature intended “a mechanism for a utility to recover out-of-pocket expenditures associated with its implementation of energy-efficiency programs, not to compensate a utility for any associated lost revenues attributable to those programs.”). The Commission concludes that lost revenues are not “the actual costs incurred in providing electricity supply service through . . . efficiency programs” or “directly related to the purchase of electricity.” Mont. Code Ann. § 69-8-103(8). As a result, lost revenues are not “electricity supply costs,” and the Commission reverses previous orders that concluded otherwise.

Conclusion

65. For the reasons discussed in this *Final Order*, the Commission concludes that it is no longer reasonable or in the public interest to allow NorthWestern to collect lost revenues through electric and gas supply rates.

ORDER

IT IS HEREBY ORDERED THAT:

66. Prior Commission orders and policies that have allowed NorthWestern to recover lost revenues through electric and gas supply rates are reversed;

67. Effective December 1, 2015, NorthWestern may not recover any lost revenues through electric and gas supply rates;

68. Starting with its November filings, NorthWestern exclude all lost revenues, including both cumulative and forecasted lost revenues, from future calculations of monthly electric and gas supply rates; and

69. For the 2015-2016 tracking period, NorthWestern may propose to true-up lost revenues that were actually and prudently incurred from July 1, 2015 through November 30, 2015.

DONE AND DATED this 15th day of October, 2015, by a vote of 5 to 0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION


BRAD JOHNSON, Chairman


TRAVIS KAVULLA, Vice Chairman


KIRK BUSHMAN, Commissioner


ROGER KOOPMAN, Commissioner


BOB LAKE, Commissioner

ATTEST:


Aleisha Solem
Commission Secretary

(SEAL)