

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

In the matter of the amendment of) HYDRODYNAMICS, INC.'S COMMENTS
ARM 38.5.1902 pertaining to) ON THE PROPOSED AMENDMENT TO
Qualifying facilities) ARM 38.5.1902

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INTRODUCTION

Hydrodynamics, Inc., ("Hydrodynamics") acting by and through counsel, hereby submit these comments pursuant to the Montana Public Service Commission ("Commission") MAR Notice No. 38-5-214 (Dated October 17, 2011). The Commission requested oral and written comment on proposed revisions to A.R.M. § 38.5.1902(5), and counsel for Hydrodynamics made an oral presentation on November 18, 2011. These written comments should be considered supplemental to oral comments made by Hydrodynamics at the Commission hearing of November 18, 2011.

Hydrodynamics is interested in developing small hydroelectric projects up to and including those up to the current 10 MW threshold. Hydrodynamics owns and operates hydroelectric projects in conjunction with governmental entities such as Granite County or farmers and ranchers who wish to develop their water resources. Hydrodynamics has been active in the Montana QF process for many years, and has been active in participating in many Commission proceedings.

The proposed revisions to A.R.M. § 38.5.1902(5) are essentially two-fold: reducing the threshold for the standard offer from 10 to 2 megawatts ("MW") and eliminating the need for utilities to conduct "all source competitive solicitations" and instead replacing this language with competitive solicitations. At the outset, Hydrodynamics assumes that the rationale for these changes in the rule are prompted by NorthWestern Energy's ("NWE") recent efforts to acquire more wind resources for its generation portfolio, including NWE signing five Qualifying Facility ("QF") contracts totaling roughly 50 MW, and NWE's build own transfer agreement with the 40 MW Spion Kop wind project. In Hydrodynamics' view, these recent wind power contracts are an insufficient reason to lower the threshold from 10 MW to 2 MW.

The Commission reached its final decision on increasing the 10 MW threshold in final order 6501f in consolidated dockets D2003.7.86, D2004.6.96, D2005.6.103 on December 19, 2006.¹ From that date

¹ Although there is reference to final order 6501g of June 7, 2007 as the date the Commission increased the threshold, this is contrary to Commission regulation A.R.M. § 38.2.4086(2), which states:

(2) Effect of filing. Motion for such a reconsideration shall not excuse any corporation or person or public utility from complying with or obeying any order or decision or any requirement of an order or decision of the commission, or operate in any manner to stay or postpone the enforcement thereof except as the commission may by order direct as provided by law.

Thus, the increased threshold was established as of December 2006, rather than June of 2007.

until 2011, no new QF contracts of any kind were signed by NWE. This delay was not the fault of QF developers who doggedly attempted to obtain contracts from NWE and even sought Commission intervention with little success.² Attempts by QF developers to obtain standard offer contracts were met largely with indifference or outright obstructionism by NWE. The fact that NWE has finally, after five years, signed five QF contracts does not mean that NWE is complying with the Public Utility Regulatory Policies Act of 1978 ("PURPA"), nor does it eliminate the need for a standard offer contract at the 10 MW level.

I. THERE IS NO JUSTIFICATION FOR LOWERING THE STANDARD OFFER RATE FROM 10 TO 2 MW.

The purpose of "standard offer" contracts is to permit smaller QFs, i.e., those that lack adequate resources to negotiate or litigate individual contracts, an opportunity to build and construct their facilities without having to expend considerable resources on negotiating power supply arrangements with utilities, or to litigate over contract terms and conditions should negotiations prove unfruitful. Until very recently, the existence of the standard offer contract has not resulted in any new QF contracts due to other barriers to entry that impede the development of small QF generation. Included among these barriers:

- Montana's current PURPA implementation scheme does not include a standard offer contract in a form approved by the Commission which eliminates disputes over non-price contract terms and conditions. As a competitor to QF developers, the utilities have little incentive to reduce barriers to entry and often engage in lengthy delays in responding to requests for contracts or take unreasonable postures with respect to contract terms.³ An example is Hydrodynamics Flint Creek Project. Flint Creek had agreed with NWE for many months that it would accept the standard QF-1 rate, yet could not get NWE to agree on other non-rate contract terms. Flint Creek is still locked in a dispute with NWE over contract terms in Commission Docket D.2011.8.68. Having a standard offer contract would eliminate many disputes and allow QF developers to simply accept or reject the standard offer without resort to expensive negotiation and litigation with the delays that those processes entail.
- Any project less than 2 MW would face considerable economic and regulatory barriers that would prove extremely difficult to overcome. In particular, hydroelectric facilities have significant transaction costs associated with developing their projects that are not shared by wind development. First, hydroelectric facilities are required to obtain a license from the Federal Energy Regulatory Commission ("FERC") at a substantial cost and with a limited time frame for utilizing that FERC license. Second, proposed hydroelectric generators require

² *E.g., In the Matter of Kenfield Wind Park, I.,* Docket D2010.2.18. The Commission declined to even make the Kenfield project eligible for a standard offer contract despite the Commission adopting a new rule on project aggregation during the proceeding. In addition, the Commission offered no path for a 20 MW project to obtain a contract offering only the empty "solicitation" process that has yet to produce a single QF project as a winner.

³ An example of this obstructionism is NWE's request for declaratory ruling to construe A.R.M. §38.5.1903(1)(iii) to permit economic curtailment despite years of consistent interpretation of FERC Order 69 prohibiting just such a construction of 18 C.F.R. § 292.304(f).

additional environmental studies and other regulatory compliance procedures beyond those typically those faced by wind developers. Hydrodynamics does not wish to minimize the development issues faced by wind developers, but feels compelled to point out that hydroelectric developers face another layer of regulation not shared by wind development projects. Hydrodynamics does agree that economies of scale and the fixed costs associated with any generation project make it difficult for a developer to build a quality facility of less than 2 MW. There is consistent testimony regarding this economic reality in the Commission's recent dockets and during oral comments offered at the public hearing on this matter. In the past, few QF developers were able to develop plants under the 3 MW standard offer threshold. Hydrodynamics believes that between 1995 and to date, only one QF project greater than 2 MW was built and constructed in Montana, and it was accomplished using refurbished equipment. If the Commission wishes high quality QFs that are reliable and produce high net capacity factors, reducing the threshold to 2 MWs would virtually eliminate such projects.

- The elimination of rate Option 3 in the Commission's most recent QF-1 rate order in Docket D2010.7.77 has likely eliminated any new wind projects for the foreseeable future as the integration charge associated with wind development in the current tariff creates a significant barrier to entry.

Taken together, the Commission's actions to date defy PURPA's mandate that the Commission "encourage" QF generation. Instead, most Commission decisions have actively discouraged such generation from being developed in Montana. Now, the Commission proposes to eliminate the one positive step it has taken toward encouraging QF generation. Regardless of whether any or all of the 50 MW of QF wind projects under contract are fully built and deliver output to NWE, as long as NWE has a need for energy and capacity – and it does – the Commission cannot use its rules as a pretext to prevent QF development in Montana. As will be discussed below, given that the solicitation process has proven a dead end for QF developers in Montana, reducing the standard offer from 10 MW to 2 MW will eliminate QF development in Montana in its entirety. FERC recently stated in *Cedar Creek Wind, LLC*, 137 FERC ¶ 61,006, Docket EL11-59-000 (October 14, 2011), that state Commission's discretion to implement PURPA is not unlimited:

Idaho PUC and other protestors interpret *West Penn's* discussion to give broad discretion to the states as to what constitutes a legally enforceable obligation and when such obligation is incurred. We disagree. While *West Penn* stands for the notion that the Commission gives deference to the states to determine the date on which a legally enforceable obligation is incurred, such deference is subject to the terms of the Commission's regulations.

Id. at p. 14, ¶ 35.

There is no question but that the Commission's regulations are not designed to encourage the development of QF resources. There is also no question but that the Commission's actions collectively have *discouraged* QF generation. The Commission's proposal to reduce the standard offer tariff threshold from 10 MW to 2 MW is a significant step in the wrong direction.

II. Eliminating the “All Source Competitive Solicitation” Requirement from A.R.M. § 38.5.1902(5) Does Nothing to Fix the Problem for Projects Above the Standard Offer Threshold

The Commission’s proposal to eliminate the “all source” terminology from the competitive solicitation requirement is perhaps understandable but does not eliminate any barriers to entry for projects above the standard offer threshold. NWE has contracted only with projects at or below the current 10 MW threshold. Thus, for projects above 10 MW, PURPA has been a virtual dead letter in Montana. The Commission’s proposal to reduce the threshold to 2 MW will likely thus eliminate any QFs in Montana, which would constitute a violation of PURPA.

The Commission’s proposed rule would impose the tender mercies of NWE’s competitive solicitation process on QF projects greater than 2 MWs. There has been no NWE solicitation process conducted by NWE which has resulted in the selection of any QF.⁴ NWE, as a competitor to potential QFs, has no incentive to run a process that encourages the selection of QFs and has not in fact done so. The history of NWE’s competitive solicitations for new generation (as opposed to short-term solicitations) reveals the following winners of those competitive solicitations:

- Basin Creek, a roughly 40 MW gas fired plant. QFs would not qualify as Basin Creek is not a renewable generator and is not a cogeneration facility.
- The 130 MW Invenergy Project located near Judith Gap, Montana. Judith Gap is not eligible for treatment as a QF because it is greater than 80 MW. QFs would not have been eligible to win such a solicitation.
- Dave Gates Generating Station, a NWE-owned gas fired generator used ostensibly for system regulation. No QF would be eligible to win this competition because this resource is not cogeneration and is not a renewable resource.
- Colstrip 4, NWE’s purchase of existing coal-fired generation. QFs would not have been eligible to win this solicitation.
- Spion Kop, a 40 MW wind project to be owned by NWE pursuant to a build-own-transfer agreement. Although QFs were eligible to be selected pursuant to NWE’s competitive solicitation, NWE ultimately changed from a solicitation process to acquire power purchase agreements with wind generators to a bilateral negotiation to purchase a wind generator.
- Turnbull Hydro, a 13 MW “project” (two projects, really) was originally a QF, but received a contract from NWE as a non-QF after a solicitation of some sort. QFs could not at that time reasonably expect to participate in this solicitation due to NWE’s then extant unreasonable and discriminatory interconnection policy.

⁴ NWE attempted to use Turnbull Hydro as an example of a QF project that won a competitive solicitation. However, this claim is at best misleading. Turnbull Hydro was a QF and abandoned its QF status when NWE informed Turnbull it would be considered a network resource for interconnection purposes and would have to pay for substantial transmission system improvements. In exchange for avoiding payment of such transmission system improvements, Turnbull Hydro dropped its QF status so as to be treated as an energy resource. NWE’s prior approach to QF interconnection was rejected by the Commission in the *Kenfield* proceeding, Docket D2010.2.18. Hydrodynamics wishes to note that NWE has continued to impose differential treatment on QFs for purposes of interconnection than it has on its own projects, e.g., Spion Kop.

Regardless of whether these were “all source competitive solicitations” (and they were not), the fact is that no QF of any size has ever won any of these “competitive solicitations.” The potential universe of QF contracts in excess of the standard offer process is an empty set, and with NWE as the decision maker, unless the competitive solicitation rules are revised there is simply no avenue for a QF larger than 2 MW to obtain a contract should the proposed revisions to A.R.M. § 38.5.1902(5) be adopted by the Commission.

QFs have no problem participating in competitive solicitations if they are regularly and timely conducted and produce a fair and unbiased result. But the competitive solicitation process is expensive and time consuming for QFs – and in Montana, unlikely to result in anything other than rejection by NWE. NWE, as a competitor to QFs, has little incentive to contract with any QFs, and NWE’s history of competitive solicitations shows that even when NWE offers competitive solicitations, it does not enter into contracts with QFs.

If the Commission intends to subject QF projects greater than 2 MW to a competitive solicitation process, the Commission needs to ensure that the process is open, fair, and vetted by a third party that is not under contract to NWE.⁵ California has recently adopted a competitive solicitation process known as the Renewable Auction Mechanism (“RAM”). California’s process provides, among other things, for independent viability analysis and substantial agency involvement in determining winners and losers of the auction. The California Public Utility Commission itself retains jurisdiction over the process to ensure fairness to both competitors and to ratepayers. For the Commission’s convenience, Hydrodynamics is attaching the entire RAM order to these comments.

Ultimately, the point is that NWE, whether it intends to do so or not, has the ability to pick winners and losers and even change the process (as was done in Spion Kop) to produce a result favorable to NWE. Whether NWE views itself as a competitor to small QFs, it is in fact a zero sum game in that any QF projects built to serve NWE’s load will not be served by rate based NWE generation assets. NWE will continue to have a need for energy and capacity for the foreseeable future, and the Commission needs to ensure that NWE is not engaging in gamesmanship so as to rig these competitive solicitations in its favor.

CONCLUSION

There is simply no need at this time for the Commission to amend A.R.M. § 38.5.1902(5). The Commission may fear that NWE’s system will be overwhelmed by an influx of 10 MW QF projects applying for the current standard offer rate, but the fact is that no such influx is likely to materialize. In addition, the Commission has no authority under PURPA to arbitrarily limit the number of QF projects as

⁵ NWE has argued that Lands Energy is a third party, but it contracts with NWE to perform its competitive solicitations. Hydrodynamics gains no comfort from a process that is run by a party under contract with NWE. Whether Lands Energy is involved in the process or not, it is clear that NWE makes the ultimate decision as to what resources NWE will acquire.

long as NWE has a need for energy and capacity. If NWE acquires sufficient generating resources such that NWE needs no additional capacity, NWE's avoided cost rate will reflect the reduction of the avoided capacity payment in the avoided cost rate such that obtaining financing to build additional QF facilities will be difficult if not impossible.

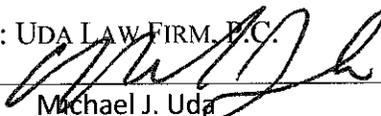
QF projects 2 MWs or less will not likely produce high quality projects that provide the sort of reliability that the Commission has sought in the past. QF projects less than 10 MWs but greater than 2 MWs simply do not have the resources to engage in lengthy negotiations or litigation should negotiations fail. Reducing the standard offer threshold from 10 MW to 2 MW will likely eliminate PURPA in Montana.

The competitive solicitation process currently run solely by NWE is highly biased and produces results favorable to NWE. Without an actual independent third party to conduct viability analysis and to monitor the process, this situation will not change.

The Commission has not acted to encourage QF generation in Montana, and the proposed rule changes are a step in the wrong direction. The Commission should not approve the proposed revisions to A.R.M. § 38.5.1902(5).

RESPECTFULLY SUBMITTED THIS 25TH DAY OF NOVEMBER, 2011.

BY: UDA LAW FIRM, P.C.


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CERTIFICATE OF SERVICE

The foregoing was e-filed and the original was hand-delivered to the following on the 25th day of November, 2011:

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