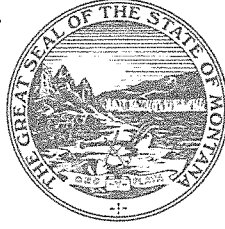


Montana Public Service Commission



Brad Johnson - Chairman
Travis Kavulla - Vice Chairman
Roger Koopman - Commissioner
Bob Lake - Commissioner
Tony O'Donnell - Commissioner

May 2, 2017

The Honorable Steve Bullock

Dear Governor Bullock:

We write you today to express the Public Service Commission's unanimous support for House Bill 193, and to urge that you sign it into law. This bill would eliminate one of the most significant, anti-consumer elements that remains on the books of Montana's deregulation-era statutes. This important, bipartisan piece of legislation should become law for four reasons:

Repeals a Relic of Deregulation

Today, HB 193 repeals a special privilege that benefits a single company, NorthWestern Energy. This law is a relic of Montana's failed experiment with deregulation. It was intended for a time when NorthWestern Energy (and, before it, Montana Power) did not own any power plants. It met all its obligations as a "default supplier" by purchasing power on the market to supply customers. It was anticipated that, in time, this role would fade away as a competitive market for electricity took hold, which never occurred. In those years, the law's dollar-for-dollar pass-through mechanism was appropriate for NorthWestern for two reasons. First, if customers did not like receiving their power supply from NorthWestern, they could always switch, it was theorized. Second, NorthWestern bought 100% of its customers' power supply from the market, and it re-sold that power to customers without a mark-up. In other words, there was no "risk for reward" dynamic in its power-purchase activities. As such, the current law shielded NorthWestern from any of the ordinary business risk that might befall power generators.

Those circumstances have dramatically changed. Nearly all customers in NorthWestern's service territory receive power supply from NorthWestern, and they have no choice in provider. Meanwhile, NorthWestern obtains a majority of its power supply from power plants that it owns, and earns a considerable return on its investment in them. NorthWestern's authorized annual return on equity for its power-plant investments is about 9.9%; expected fixed cost recovery for these plants for the next year is about \$262 million. It is a well-established principle of utility regulation that risk should follow reward, but the current law's mandatory pass-through mechanism makes it impossible for the PSC to establish a mechanism by which NorthWestern is predictably held accountable for its role in supplying its customers with power.

Today, unlike a decade ago, NorthWestern is a financially sound corporation; however, its rates are among the highest in the region for investor-owned utilities. It is time to provide for policies

that will incent the utility over the long term to reduce costs to its customers.¹ HB 193 helps to put the state on that trajectory.

Restores an Important Performance Incentive

HB 193 restores an important incentive for NorthWestern Energy to reduce costs to customers. Utility commissions throughout the northwest region provide something similar to a budget to their regulated utilities, instead of the dollar-for-dollar tracker that appears in Title 69, Chapter 8 and applies only to NorthWestern Energy. Under the normal mode of utility regulation, a budget is calculated in advance, based on the costs of owning and operating a utility's fleet of power plants and the projected cost of market purchases to supplement the production (or market sales to liquidate the surplus) of those power plants. If the company goes above budget, or under budget, it shoulders the consequences of its performance—up to a certain point where the costs in excess of, or savings below, the budget baseline are subject to a sharing mechanism, splitting them between the utility's shareholders and its customers. This type of regulation aligns the company's incentives with the goal of lowering customers' bills. Already, the PSC has a 90%-10% sharing mechanism for Montana-Dakota Utilities. The PSC is confident that this has given MDU a more robust incentive than NorthWestern currently has to minimize these costs, yet establishing such a mechanism for NorthWestern is not permitted under existing law.

Fixes a Broken Process

The current cost tracker that HB 193 addresses is hopelessly flawed, and administrative reform is not sufficient to fix it. While the words of the current law may seem innocuous, they are not. By prescribing that the PSC allow NorthWestern to “fully recover” (MCA 69-8-210(1)) a set of costs with an extremely broad definition (MCA 69-8-103(8)), the PSC is prevented from establishing the kind of budget and performance standard that is typical across the region, and which is described above. The current tracker allows NorthWestern to file an application with annual costs in excess of \$100 million. These costs are summed up from a large number of invoices, and presented in summary form on Excel spreadsheets that NorthWestern files with its application. Since the PSC cannot disallow costs that the company files with the PSC, unless they are found to be imprudent, NorthWestern effectively shifts the burden of poring through these invoices to the PSC and the Montana Consumer Counsel (MCC). The current law is essentially a game of “Go Fish,” and the PSC and the MCC are not equipped, and should not be in the role, for the micromanagement of NorthWestern's voluminous invoices. It would be preferable to set NorthWestern on a budget from the beginning, providing the utility with a clear incentive to operate efficiently and control costs.

Provides Badly Needed Consumer Protection

The PSC has uncovered disturbing examples of the current law being used to track costs it believes are inappropriate. This includes consulting fees amounting to \$12 million over the past

¹ Customers, meanwhile, are taking notice. The PSC and the Legislature received a petition of nearly 4,000 signatures earlier this year asking us to exert more oversight over NorthWestern's rates, which the petitioners believed to be excessive. The Commission has not received such a volume of public comment in nearly a decade.

decade, including, as revealed in testimony to the legislature, a receipt for Jamba Juice. (Again, it should not be necessary for the utility regulator to review every \$5 invoice, but the PSC has tried to do so.) The PSC does not know how often unwarranted costs have slipped through the cracks, but it is probable that oversights have occurred. Additionally, even small disallowances by the PSC result in litigation by NorthWestern. Indeed, the last four years of the tracker have all been litigated. The PSC has prevailed in every judicial decision; however, these proceedings consume a great deal of agency resources. These are resources the PSC would otherwise devote to a more robust examination of NorthWestern's costs. HB 193 is an important tool for better oversight of NorthWestern, which customers expect.

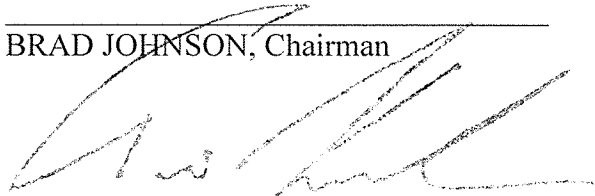
In addition to this cover letter, the PSC is transmitting to you two appendices to assist in your decision on this legislation. *Appendix A* provides a roadmap of the process the PSC intends to use to implement this law. *Appendix B* is a response to criticisms of the legislation that were raised in committee hearings and lobbying by NorthWestern.

In conclusion, we urge you to take an important step for consumer protection and the appropriate regulation of monopolies, and to sign HB 193.

Sincerely,



BRAD JOHNSON, Chairman




TRAVIS KAVULLA, Vice Chairman



ROGER KOOPMAN, Commissioner



BOB LAKE, Commissioner



TONY O'DONNELL, Commissioner

Appendix A

HB 193 implementation

PURPOSE

The purpose of this memo is to describe how the Commission can implement HB 193, which eliminates the mandatory electricity supply cost tracker in Mont. Code Ann. § 69-8-210(1) effective July 1, 2017. The implementation options described reflect the use of standard Commission procedures that provide for due process and balancing the interests of both public utilities and customers.

BACKGROUND

The mandatory electricity supply cost tracker in Mont. Code Ann. § 69-8-210(1) only applies to NorthWestern Energy (“NorthWestern”) and was initially designed to facilitate NorthWestern’s provision of “default supply service” under deregulation. NorthWestern’s statutory tracker adjusts its electricity supply rates on an interim basis each month to follow changes in supply costs. This process follows an annual cycle that runs from July 1 through June 30. Each year, usually in May, NorthWestern files an application requesting final approval for the supply costs it incurred in the prior year.

HB 193 eliminates the mandatory electricity supply cost tracker in Mont. Code Ann. § 69-8-210(1) while leaving the Commission the discretionary authority to implement a tracker under the general rate making procedures contained in Chapter 3 of Title 69. HB 193 has an effective date of July 1, 2017, which corresponds with the end of NorthWestern’s current annual tracker cycle. After that date the Commission cannot reauthorize NorthWestern to track supply costs and make interim rate adjustments, under Mont. Code Ann. § 69-8-210(1), for the July 1, 2017 to June 30, 2018 time period.

ANALYSIS

With HB 193, the Commission retains authority to implement cost trackers for public utilities. The Commission already administers an electricity tracker mechanism for Montana-Dakota Utilities Co. (“MDU”) by virtue of Chapter 3 of Title 69, regarding regulation of utilities; Title 2, Chapter 4, regarding administrative proceedings; and the Commission’s rules regarding the filing of utility rate change applications, pursuant to Mont. Admin. R. 38.5.101 through 38.5.195. MDU’s “Fuel and Purchased Power Tracking Adjustment” allows it to track changes in purchased power costs in excess of, or below, the baseline power-supply costs included in rates. It also provides for a cost-sharing mechanism when the company comes in above or below expectations, unlike the tracker required by Mont. Code Ann. § 69-8-210(1), which prevents this treatment. *See In re Montana-Dakota Utilities Co.’s 2007 Electric Rate Case*, Docket D2007.7.79, Order 6846f pp. 4, 15 (Mont. Pub. Serv. Comm’n Apr. 23, 2008) (establishing, through stipulation, MDU’s Fuel and Power Tracking Mechanism). Additionally, every state in the Pacific Northwest—Oregon, Washington, Idaho—uses a similar rate adjustment procedure.² Since the Commission already has experience administering an incentive-based tracker for one electric utility, it can take up the matter promptly for NorthWestern, if HB 193 is signed into law.

² See *In re Avista Corp.’s Annual Power Cost Adjustment*, Case AVU-E-14-06, Or. 33140 (Id. Pub. Util. Comm’n Sept. 30, 2014), *In re Puget Sound Energy’s Power Cost Adjustment*, Docket UE-140526, Or. 01 (Wash. Util. Transp. Comm’n Nov. 26, 2014), *In re Portland General Electric’s Power Cost Variance Mechanism*, Docket UE 291, Or. 14-345 (Or. Pub. Util. Comm’n (Oct. 3, 2014).

For its part, NorthWestern has at least three options for obtaining Commission approval to continue to track electricity supply costs after July 1, 2017: 1) a rate case, 2) a stand-alone application, or 3) a request for a new tracker mechanism as part of its soon-to-be filed annual application for final approval of tracked supply costs for the period July 2016 – June 2017. The Commission would convene a meeting to scope these options, although any party, NorthWestern or the Consumer Counsel, ultimately retains a right to make filings to the Commission. A Commission interim order could provide a bridge for NorthWestern to continue tracking electricity supply costs pending a Commission decision that balances the interests of NorthWestern and its customers. The Commission currently has authority to implement interim rate adjustments under Mont. Code Ann. § 69-3-304 and Mont. Admin. R. 38.5.501 through 38.5.508.

Appendix B NorthWestern Energy Criticisms of HB 193

The only opponent to raise substantive objections to this bill was NorthWestern Energy. This appendix replies to each of the company's criticisms. To the extent that new arguments arise, the PSC is willing and eager to respond to them.

NWE Claim #1: The bill is punitive to NorthWestern.

The plain text of HB 193 disproves this claim. This legislation simply allows the PSC "to approve a cost-tracking adjustment for a public utility regulated under this part consistent with its regulation of public utilities under Title 69, chapter 3." As the bill's title provides, this legislation is about "standardizing the treatment of public utilities." Montana-Dakota Utilities is already subject to Title 69, chapter 3, and Montana Power Company was subject to this chapter for many decades. This bill is not about being punitive to NorthWestern. It is about recognizing that their business model has returned to one of a vertically integrated utility, after a failed attempt at deregulation. The law HB 193 reforms is a relic of that era, and NorthWestern, now that it has vertically re-integrated, should be subject to the type of regulation to which such utilities are subject to throughout this region.

Although its members often disagree, the PSC unanimously supports this legislation. We are joined in that support by the Montana Consumer Counsel and AARP, who view this reform as a critical piece of consumer protection legislation.

NWE Claim #2: NorthWestern is different than Montana-Dakota Utilities, and should not be regulated in the same way.

NorthWestern argues that, unlike MDU, it has not yet rebuilt its business into a vertically integrated utility. The facts do not support NorthWestern's argument. Both of these companies generate the majority of power that supply their customers, according to their annual reports.³ In 2015, NorthWestern was in fact less reliant on the open market for its power supply than MDU. NorthWestern is simply not accurate in its representations that its business model is substantially different from MDU. Both of them rely on the market to an approximately equal degree. In other words, NorthWestern substantially relies on its own fleet of power plants for electricity, yet it still has a mechanism that assumes a complete reliance on the open market for power. NorthWestern should not be allowed to have it both ways, simultaneously able to exist under a risk-for-reward paradigm that allows it to own and earn a return on power plants, but also to avail itself of a relic of deregulation to allow it dollar-for-dollar pass-through treatment of its power supply costs. It has chosen to purchase power plants, and the PSC has allowed the company to do so, and NorthWestern today is as vertically integrated a firm as MDU. The regulatory treatment of these two firms as to their power supply expenses should not be radically different.

Meanwhile, NorthWestern holds up the fact that it went bankrupt about a decade ago and remains subject to a bankruptcy stipulation as another point of difference. The PSC first is alarmed that NorthWestern's bankruptcy, which was caused by its prior management's business decisions, should be justification for favorable regulatory treatment. If accepted, such a view would have the effect of disadvantaging customers in perpetuity for management decisions that customers were not responsible for. Even if that were not the case, the bankruptcy stipulation

³ Compare Schedule 33, Annual Reports of NorthWestern Energy and Montana-Dakota Utilities, 2016 and 2015.

has nothing to do with the regulatory treatment of power supply costs. The bankruptcy stipulation limits NorthWestern's ability to engage in risky side businesses, such as fiber optics or HVAC, in light of the corporation's history. Linking the bankruptcy stipulation to how power supply costs are treated in utility ratemaking is a red herring argument.

NWE Claim #3: The PSC already has disallowed costs under the current law, such as plant outage costs, so the bill is unnecessary.

The current tracker works like a credit card with no credit limit—the regulator is required to hand over the charge card, it receives summaries of invoices at the end of the year, and then a game of “Go Fish” begins as the PSC and Consumer Counsel attempt to investigate the prudence of each. The information asymmetry between the utility and these parties make this an effort that is almost sure to fail, as the introductory letter explains.

HB 193, meanwhile, allows the PSC to set up a budget for spending beforehand and establish expectations about the utility's performance, in exchange for its return on investment in power generation facilities. This is a best practice of utility regulation, which currently is not permitted in Montana because of the law this bill reforms.

NorthWestern's view would absolve itself of much responsibility for the performance of its property. Consumers are paying for that property, and they expect a certain level of performance from it. If its argument is accepted, NorthWestern would shift the bulk of the risk of owning and operating a power plant to its captive set of customers, the people who are least able to make managerial decisions in relation to whether to acquire a power plant and how to run it. HB 193 would allow the PSC to set up performance expectations in advance. If a plant performs at or above expectations, the company is rewarded; if it does not, then the company shoulders some of the consequences.

It should also be noted that while NorthWestern has made the argument in legislative hearings that the current law allows the PSC robust powers of oversight, it has made numerous arguments in court that the law significantly limits the power of the PSC to protect customers. While the PSC has succeeded in defending its orders and hopes to continue to prevail in current litigation, NorthWestern has argued two different things to the legislature and the judiciary.

NWE Claim #4: This bill will cause NorthWestern to go bankrupt.

This argument conflicts with NorthWestern's earlier claims that the bill is unnecessary because the PSC already has the powers to do what it would do under HB 193. Clearly the bill cannot both be trivial and also doom NorthWestern.

NorthWestern shows robust earnings, its stock has outperformed the shares of other utilities doing business in the state, its dividend continues to grow, and its credit rating is sound. NorthWestern notes Moody's has downgraded NorthWestern's unsecured debt recently. This is true. However, as Moody's itself explained, the downgrade is primarily the result of a lower income to debt ratio, which is to be expected when a firm takes out unusually large debt issues to make big purchases, as NorthWestern did in its \$870 million purchase of hydroelectric facilities less than three years ago. The downgrade was largely the inevitable result of this strategic decision on the part of the company. Even so, the current rating from Moody's is in the average for regulated utilities in the United States, and is sufficient to support investment.

NWE Claim #5: The PSC should not have disallowed outage costs at Colstrip.

The PSC does not understand how this issue is relevant to the present legislation. The PSC undertook a lengthy review of the 2013 plant outage and Colstrip and, after hearing from the Montana Consumer Counsel and the Montana Environmental Information Center, concluded that NorthWestern had not done what it should have to minimize the possibility of a plant outage or its consequences. The evidentiary record of the proceeding in question spans thousands of pages, and the points on which the PSC relied are recorded in our Order 7283h.⁴ NorthWestern is currently litigating the matter before a Billings District Court.

The PSC does believe this issue may be relevant in one way which the Order alludes to.

Evidence in the proceeding showed that NorthWestern was less aggressive about managing risks than other utilities.⁵ The Commission surmises that this more lackadaisical approach is due at least some degree to NorthWestern's presumption that it can recover all the costs resulting from a plant outage, dollar for dollar, from consumers under current law (Indeed, bizarrely, NorthWestern's proposal in the case, based on its interpretation of the law HB 193 reforms, would have allowed it to pocket savings from furloughing workers during the outage, while leaving customers to reimburse all the costs of replacement power). Other utilities who own shares of Colstrip, meanwhile, have a cost-sharing mechanism which provides a clear financial incentive to avoid plant outages and generally reduce costs.

NWE Claim #6: The bill would automatically cause NorthWestern to lose 10% of its revenue.

NorthWestern is apparently referring to—and misstating—the concept behind a cost-sharing mechanism, such as the PSC has already implemented for MDU. In that example, a budget is established for MDU for its purchased power and fuel costs, and if the company is above or below budget, the resulting excess costs or cost savings are shared between customers and shareholders, with 90% flowing to the former and 10% to the latter. This is not a dispossession of revenue. It is a basic incentive to reward efficient performance. Importantly, it is symmetrical—the utility has both an upside and downside opportunity to motivate its performance. Utilities subject to cost-sharing or performance-based regulation have shown gains in productivity. This type of regulation is typical in the United States, and it is unusual that NorthWestern is not already subject to it. HB 193 would remedy this abnormality.

⁴ Order 7283h (May 13, 2016), Docket No. D2013.5.33, available online at: <http://psc.mt.gov/Docs/ElectronicDocuments/pdfFiles/D2013533FO7283h.pdf>

⁵ *Id.*, ¶¶ 67-68.