

# MONTANA PUBLIC SERVICE COMMISSION

1701 Prospect Avenue PO Box 202601 Helena, MT 59620-2601 Telephone: 406-444-6166 FAX #: 406-444-7618 E-MAIL: tkavulla@mt.gov

Aug. 27, 2013

#### Dear ETIC Members:

I'm writing to express my view that the Economic Impact Statement (EIS) prepared by the Public Service Commission in relation to its proposed amendments to the PSC's Qualifying Facilities Rule (ARM §38.5.1902) is flawed in two fundamental ways.

- First, the EIS fails to discuss alternative methods that could better achieve the purpose of the proposed rule. Although the PSC has considered these approaches, the document is silent on them, and does not discuss why the current approach is favored over more thorough, fair approaches. The absence of a consideration of alternatives in the EIS is contrary to law. MCA §2-4-405(2)(f).
- Second, the calculation of benefits the adoption of the rule will supposedly provide is erroneous, predicated on a false assumption and an error in data.

I will elaborate on each of these matters in this letter-memorandum.

#### Better Alternatives to the Proposed Rule Exist

#### I. Improvements to competitive solicitations

This proposed rule is predicated on the notion that competitive solicitations are a superior method to arrive at true market prices than an administratively established standard rate. This is true, but it comes with a significant caveat. In order for the objective of market access for QFs to really mean anything, it should not be enough merely to invoke the words "competitive solicitation"; rather, that solicitation process must be credible, transparent, and even-handed to all comers. There is still much work to be done in Montana in this respect.

In October 2011, the PSC proposed a rule similar to the one under consideration today. That rule would have limited the availability of a standard offer to QFs smaller than 2 MWs, and would have caused QFs larger than that size to bid into competitive solicitations. During the rulemaking, extensive public comments were submitted expressing the view that Montana's regime of competitive solicitations—where the utility is both the arbiter of the solicitation, and

also stands to gain (or lose) a profit opportunity depending on who wins the bid—lacked necessary oversight to ensure the solicitation was really "competitive."

Members of this committee must understand an essential fact about their and the PSC's mission: The utilities the PSC regulates are monopolies. They control the supply of power to hundreds of thousands of Montanans, who are captive customers. The only opportunity an independent developer of a generating plant has to sell power to those customers is through the monopoly middleman, the utility.

Unlike other businesses, the utility does not have a strong financial incentive to limit its costs or to obtain the least-cost power. In fact, an opposite incentive exists. The utility earns a return on capital investments it makes; the larger the investment, the greater the profit. At the same time, if the utility buys power from a third party, rather than producing it itself, the utility earns no profit; it simply passes along dollar-for-dollar the cost of the power purchase contract to consumers.

Accordingly, two strong tendencies exist in the utility business model that, if left unchecked, will harm consumers: 1) a "self-dealing" incentive and 2) an incentive to make capital investments in excess of what is necessary for reliable electric service, in order to earn a greater return.

Independent power producers, including QFs, provide a useful benchmark that helps the PSC check against these pernicious incentives.

The Oct. 2011 rule was proposed for adoption unanimously on a bipartisan basis. In the end, in April 2012, it was also rejected on a bipartisan basis, after PSC staff recommended that the Commission abandon the rulemaking in order to address commenters concerns regarding the competitive solicitation process employed by NorthWestern Energy.

The Commission then applied for a grant to the National Association of Regulatory Utility Commissioners to hire a consultant to host workshops leading up to a re-write of the PSC's competitive solicitation and resource planning rules. The Commission opened a docket, N2012.5.56, and hired Pamela Morgan, a former utility executive and lawyer who is an expert on such rules, and Martin Howard, an analyst who is a subject-matter expert in resource planning.

After hundreds of hours of stakeholder meetings and research into the practice of other states, Ms. Morgan and Mr. Howard submitted an extensive report to the PSC. It found that the Commission's competitive solicitation rules did not meet industry best practices and exposed consumers to unnecessary risks through inadequate planning and oversight of the utility procurement process.<sup>1</sup>

This report should have been the basis for any rulemaking; unfortunately, it barely warrants a mention in the EIS, much less a discussion of its recommendations. The rule changes that Ms.

<sup>&</sup>lt;sup>1</sup> Pamela Morgan & B. Martin Howard, *Recommendations and a Draft Rule for Electric Utility Resource Planning and Procurement in Montana*, Sept. 2012, available online at www.psc.mt.gov in Docket No. N2012.5.56.

Morgan and Mr. Howard proposed would have reduced the standard offer to QFs, but they would also have ensured a more competitive solicitation process through requirements that the utility make available its RFP for comment before issuance, that an independent monitor observe the process for any self-dealing abuses, and that resource planning (the identification of what the utility actually needs) be improved to mitigate the anti-consumer incentive to build plants beyond what is necessary to serve consumers.

Such an approach has been adopted in other Western states, including Utah and Oregon, and it would have been a step toward a more genuinely competitive framework.<sup>2</sup> Adopting (or at least considering) this approach in Montana would create a more healthy atmosphere for investment and would deliver more value to consumers.

## II. A reverse Dutch auction model of standard offers

Another alternative involves a hybrid of the competitive solicitation and standard offer models. In this framework, a competitive solicitation would occur, and the winning bid price would then also be offered to independent generators under a certain size, allowing them to compete by building a facility at the same price that emerged from a competitive solicitation. Like the other option described above, this option—which is being adopted elsewhere in the country—is not discussed in the EIS.

#### The Economic Analysis of the EIS is flawed

The only meaningful attempt to analyze the economic impacts in this 31-page EIS appear on pages 20 and 21. One reason for this is the inherent difficulty of analyzing the effects of this kind of rule; such analysis requires many assumptions.

But, like the problem detailed above, the EIS lacks a consideration of its own assumptions and possible alternatives.

I. The analysis is predicated on a false assumption that underestimates the cost of a utility-owned generator

When the utility owns an asset, all construction costs, operational and maintenance costs, and future capital expenses that accrue to the utility are passed on to consumers, unless those costs were imprudently incurred. If such a plant goes down, ratepayers continue to pay for the investment (and a return on it) nonetheless, in addition to paying for replacement power and the incremental capital cost required to get the plant running again.

<sup>&</sup>lt;sup>2</sup> See Utah Code §54-17-201 *et seq.* for a discussion of the competitive solicitation process and the independent evaluator in Utah. Oregon has been grappling with this issue for years, in Oregon PUC Docket No. UM 1182.

Meanwhile, for a QF, payments are structured on a per megawatt-hour basis: If you don't perform, you don't get paid. If lightning strikes a QF, and the QF stops producing, the checks from NorthWestern stop coming. If lighting strikes a utility-owned plant, and it stops producing electricity, consumers nonetheless bear the costs.

The calculation used in the EIS did not consider that risk whatsoever. The EIS instead pretends that a dollars-per-MWh rate can be derived that will make for an apples-to-apples comparison. This is a false assumption.<sup>3</sup> An addition to the "total cost" of the utility-owned project is an appropriate way to factor in this risk, but it was not applied in the EIS.<sup>4</sup>

### II. The data used to conduct the analysis is erroneous

The EIS uses a discount rate to calculate Net Present Value benefits of 7 percent. NorthWestern's last approved weighted average cost of capital, which is typically used as a proxy for the discount rate, is nearly 8 percent (to be exact, 7.92 percent). This change, while seemingly minor, results in a significant difference from the figure expressed on page 21.

### III. The economic analysis uses a tariff that is no longer available

A wind QF over 100 kilowatts already cannot sign a contract with NorthWestern today—because there is presently a 50-megawatt installed capacity limit for QFs in place. But were a wind QF able to do so, the tariff available to those QFs is not the \$69.21 per MWh used for the EIS's purposes; it is about \$48 per MWh (the cost varies slightly based on the output of the wind facility during certain peak hours and how much balancing service it requires). Again, the EIS uses a false assumption—this one of a enormous magnitude—in calculating the supposed "benefits" of the rule, and in using a tariff price that is no longer available to QFs, it fallaciously assumes that the prospective benefits of adopting the rule are somehow related to the *ex post facto* calculation the EIS provides.

# IV. The actual economic "benefits" to the rule are likely negative

When only the two flaws in subsections I and II that are detailed above are corrected, and the corrected data is used in the same spreadsheet used to perform the benefits calculation, the result is a negative number: (\$15,667,116) in total costs, or (\$1,606,257) in Net Present Value. Were

<sup>&</sup>lt;sup>3</sup> The Public Utility Commission of Oregon, for example, specifies that in comparing a utility-owned resource to an independently-owned resource, the price comparison must include a consideration of the additional risks associated with "rate-based" plants, including unanticipated additional capital expenditure and plant operations that are different than what was first expected. *See* OR PUC Order No. 06-446 at 12, Docket UM 1182, Aug 10, 2006.

<sup>&</sup>lt;sup>4</sup> To arrive at the number expressed in Section IV, I have applied a factor of 20% to represent this risk. This seems a reasonable factor to include, both because of information in the Oregon docket cited in the above footnote and because NorthWestern's own experience with its largest plant, Colstrip Unit 4, indicates that the plant will have been down due to forced outages for 11 months out of NorthWestern's approximately 4-year rate-based ownership of its part of Colstrip Unit 4 (or 23% of the time).

<sup>&</sup>lt;sup>5</sup> See the September 1, 2013 Monthly Electric Supply Cost Rate Adjustment, Exhibit FVB-2, p. 2, Docket D2013.7.53.

the false assumption discussed in subsection III to be accounted for, the number would be even more negative. The rule's adoption will cost consumers money.

Again, it is misleading for either the EIS or a document like this one to identify a precise number, but in failing to document a range of assumptions, the EIS has failed in its basic mission of providing a reasonable estimate.

#### Conclusion

One frequently hears complaints from Montana's business community about the state's lack of regulatory certainty. This rule should be that complaint's Exhibit A. At a time when others, such as Rep. Steve Daines, are pushing federal agencies to allow farmers and ranchers to make use of irrigation flows to create hydroelectric power, this is a rule that would close the door on just that type of development. Given the relatively small impact of QFs on the overall NorthWestern portfolio, it is hard to see the proposed rule as something other than an unwarranted further injection of regulatory uncertainty into the lives of small businessmen who simply want to know a price point which they can take to their bank to determine whether their projects will work.

In addition, the elimination of meaningful avoided-cost proceedings at the PSC, without a backstop policy of improving Montana's competitive-solicitation rules, will make prices less transparent and, lacking a check on its costs, the problematic incentives of utility regulation discussed at the beginning of this letter will be aggravated.

I know the committee members, both Republicans and Democrats, believe in some of the same things we at the PSC do: the development of Montana's natural resources, the importance of a level playing field for all businesses, and the protection of consumers.

Those goals are not advanced by this proposed rule, but could be advanced by a more in-depth consideration of the network of issues that I have discussed above. I hope you will provide to the Commission the appropriate direction to ensure that this fuller discussion happens, rather than allowing the PSC to move ahead with an over-simplistic attempt that will not remedy the problem it pretends to address.

Sincerely,

Fravis Kavulla

Commissioner, District 1