

Restructuring Testimony

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

IN THE MATTER of the UTILITY DIVISION
Application of) DOCKET NO. D97.7.90
MONTANA POWER
COMPANY for)
Approval of its Electric Utility
Restructuring)
Transition Plan Filed
Pursuant to Senate Bill
390.)

**PREFILED DIRECT TESTIMONY OF DR. LAWRENCE P. NORDELL ON BEHALF OF
THE MONTANA DEPARTMENT OF ENVIRONMENTAL QUALITY AND THE MONTANA
OFFICE OF THE NORTHWEST POWER PLANNING COUNCIL**

Introduction:

Q. Please identify yourself.

A. I am Larry Nordell, Senior Economist with the Montana Department of Environmental Quality, 1520 East Sixth Avenue, Helena, Montana.

Q. Please describe your educational qualifications.

A. I studied at the University of California at Berkeley where I received an A.B. degree in Economics in 1963, and a Ph.D. in 1967.

Q. Describe the positions you have held.

A. After receiving my doctorate I spent one year as a Research Officer at the London School of Economics. I then taught economics for four years at the State University of New York at Stony Brook, and four years at the University of New Hampshire.

From 1976 through 1995 I worked as Senior Economist for the Montana Department of Natural Resources and Conservation in the Energy Planning Division. Since 1995, when the state environmental agencies were reorganized, I have been Senior Economist in the Planning Division of the Department of Environmental Quality.

Q. Have you participated in any previous Commission rate cases?

A. Yes. I testified before the Commission in docket 83.1.2 on estimates I had made of the cost of electricity from a new coal-fired power plant. I also worked for the Commission as a contractor in a 1981 Pacific Power and Light case (docket 6728, phase 2) when the Commission did not have an economist on its staff. I represented the Department of Natural Resources and Conservation in Docket 88.6.15 on the issue of MPC's proposal to buy a

portion of the output of Colstrip 4 for use by its ratepayers at an avoided cost-based price. I represented DNRC in Docket 90.8.49, the Commission's inquiry into Integrated Least-Cost Planning for electric utilities. I also testified on behalf of DNRC in Dockets 93.6.24 and 93.7.29.

Q. What is the purpose of your testimony?

A. I will testify on several issues at stake in this docket: First, I will testify generally on the goals of this docket and on the goals of restructuring the utility industry. I will focus on the need for vigorous competition to replace regulatory oversight for those parts of the industry that are deregulated under restructuring, the consequences of a failure to achieve vigorous competition, and how well MPC's proposed restructuring plan complies with this goal.

Second, I will testify on the need for full functional separation of MPC's retail service function from the regulated "wires" (transmission and distribution) function in order to ensure that vigorous competition can develop. I will argue that MPC's proposal is greatly deficient in this area and that allowing MPC to mix its appropriately regulated transmission and distribution monopoly services with energy services that can and should be provided in a competitive arena will significantly handicap the development and operation of a competitive market. I will offer suggestions on how MPC's functional separation should be organized and on what the Commission should do to ensure that it is appropriately separated.

Third, I will testify on how stranded costs should be estimated to be consistent with the letter and the spirit of SB 390, in order to avoid placing undue barriers to the entry of new competitors in the Montana market. I will compare MPC's proposed estimate of its stranded costs and argue that MPC's measure is seriously flawed, and that MPC has not demonstrated adequately that it has positive stranded costs. I will offer a suggestion to the Commission on how to handle MPC's request for non-bypassable competitive transition charges to recover its estimated stranded costs, unless and until such time as MPC can provide a value that meets the standards of proof of SB 390.

Fourth, I will address MPC's proposed Delivery Service Charge, and its role as a barrier to the development of vigorous competition. I will argue that MPC's proposal is inconsistent with accepted standards of ratemaking and, as designed, makes it less attractive for customers to take advantage of the options open to them in a restructured utility market. I will suggest an alternative for the Commission and for MPC.

Finally, I will address MPC's proposal for the allocation of customers who fail to choose a supplier, and the role of this proposal in blocking the development of vigorous competition. I will recommend an alternative that will enhance competition.

Restructuring goals and vigorous competition

Q. What are the goals of this docket?

A. This docket must aim at setting up a restructured MPC and a restructured electricity market in a way that is consistent with SB 390 and that ensures that we will have a vigorously competitive retail market for electricity in the state. The decisions made in this docket will set the course of the electric utility industry in Montana for a significant period of time, as long as 30 years or more. Consequently the Commission must ensure that MPC

cannot retain control over its customer base by unfairly tilting the playing field and unfairly advantaging MPC over its competitors, and that fixed transition charges and customer charges are not set in a way that eliminates most or all benefits that could accrue to customers seeking alternate suppliers.

Q. Why is it important to have vigorous competition in the retail energy markets as well as in wholesale markets?

A. Competition serves as a brake on the ability of business entities to extract excess profits from captive markets. It forces businesses to be efficient, and encourages them to innovate by inventing lower cost technologies and by inventing new products that better serve the public. In a fully competitive market, price is driven down to the level of long run marginal cost, including the marginal cost of (or "normal return" on) tying up capital. The absence of competitive pressure allows businesses to maintain prices above that level. This may mean they can earn excess profits by maintaining prices at levels above the marginal cost of providing service, or it may simply mean they can be inefficient and allow excess costs to eat up their profits.

Regulation in the utility industry has historically served as a surrogate for competition, striving to ensure that utilities made no more than a normal level of return on their investment while allowing them a monopoly on retail service within a specified area. However, the changes in the industry away from vertically integrated utilities and changes in federal regulation now will ensure that competition prevails in the bulk, wholesale market and that wholesale prices are constrained by competition, not regulation. Similar changes show that competition may serve the same purpose in retail markets, and that regulated monopoly is intrinsic only to the wires portion of the industry. The transmission and distribution portions of the industry will need to remain under traditional regulation, but for the remainder of the industry the protection of consumers from market abuse can be left to the pressures and constraints of the competitive market.

However, for the market to protect consumers, there must be effective and vigorous competition, there must be a level playing field, and there must be easy access to the market. I will discuss below why I believe MPC's proposed Transition Plan will restrict the effectiveness of competition, and increase MPC's hold on its existing customer base by tilting the playing field in MPC's favor. To the extent this happens MPC will be able to extract prices in excess of marginal cost, to increase their profits beyond a competitive level, and to keep the benefits of competition from being realized by their customers. The result will be the worst of both worlds, with MPC becoming, in effect, a deregulated monopoly.

Q. What should be the goals of the Commission in this docket?

A. The primary goal of the Commission in the restructuring process must be to ensure that the restructuring of MPC is consistent with the requirements of SB 390. A key requirement must be to ensure the establishment of competition in retail electricity markets. These include the markets for electric power, ancillary services, and retail energy services. If the Commission fails in this goal and competitive markets fail to develop, we will see the worst possible outcome: an unregulated near-monopoly exercising its market power to extract excessively high prices from consumers. SB 390 deregulates MPC's electric supply activities and retail service, eliminating regulatory oversight over prices or earnings, and allows MPC the opportunity to recover its stranded costs, but in return SB 390 requires that consumers get the benefits of vigorous and effective competition. The Commission must ensure that restructuring yields all of these results. It must ensure that MPC does not simply free its generating assets and collect its stranded costs while keeping a lockhold on the market.

Q. What degree of competition do we need to aim for?

A. We need to have competition that is sufficiently vigorous to restrain MPC (and other suppliers) from raising prices above competitive levels. In the absence of such vigorous competition MPC would be able to exploit its market power by charging its customers higher prices and thereby extracting monopolistic profits. In this case, MPC would benefit greatly from deregulation, but customers would not.

Q. Doesn't MPC argue that its market share is too small to have any market power?

A. MPC argues that it holds only a small portion of the Pacific Northwest market. That may indicate MPC's lack of market power in the Pacific Northwest wholesale electricity market, but it does not address MPC's market power in its retail market. MPC currently holds a 100 percent market share in its service territory. It has endeavored to use its position to build customer loyalty and its proposed restructuring plan will leave it with a near unbreakable tie with its customers.

MPC witness William Shepherd argues that the existence of an effective Independent Grid Operator and an efficient wholesale power market will eliminate MPC's market power in its current service area. However, this ignores the long-term barriers that MPC proposes to build into its restructuring plan that will, if successful, provide it with long term significant market power within its current customer base. It also assumes that the creation and successful implementation of IndeGO are a certainty. To the contrary, the participation in IndeGO of the largest transmission owner in the region, the Bonneville Power Administration, is still very much up in the air, and at least two other potential participants, the Washington Water Power Company and the Public Service Company of Colorado, are likely to balk at joining because of unacceptable cost shifting. If BPA and a significant portion of other transmission owners do not participate, the effectiveness of IndeGO is very much an open question.

Q. Is MPC's proposed Transition Plan aimed at creating vigorous retail competition in its Montana market?

A. No. To the contrary, it appears to me that MPC's Transition Plan will have the effect of ensuring that MPC will continue to control the bulk of its current retail market.

Q. How will MPC's proposed Transition Plan work to help MPC keep its retail customers in the face of SB 390's mandatory choice?

A. There are a number of ways that MPC's proposal appears likely to result in MPC retaining its retail customers in the face of choice. These include:

á Retaining energy services that should be competitive as regulated services, including metering and billing. This will ensure that MPC is seen by customers as the source of their electricity, and it places MPC as an intermediary barrier in any transactions between its customers and other suppliers.

á Setting excessive CTC charges by overestimating stranded costs. This lowers the price for energy that any competitor would have to beat.

á Collecting a Distribution Service Charge as a fixed residual would ensure that no customer could reduce his bill by selecting another supplier.

á Using regulated ratepayer funds to build customer loyalty for the unregulated supply division.

á Controlling consumer education programs to keep customers and make them leery of alternate suppliers.

á Designing pilot programs that will discourage customers from selecting alternate suppliers.

á Using similar names for the regulated monopoly distribution company and the unregulated competitive supply division to confuse the public about its choices.

á After choice of supplier has been offered for 3 months, allocating customers who have not chosen among suppliers in proportion to those who have chosen; e.g. if 80 percent of those who made a choice chose MP Energy, then 80 percent of the undecided would be allocated to MP Energy.

Q. What is the likely cumulative effect of these aspects of MPC's proposed Transition Plan?

A. They make it likely that few of MPC's customers would be able to save money by switching suppliers, that those who might save money would be likely to distrust competitors and feel a strong sense of loyalty to MPC, and that most of those who are indifferent will by default remain MPC customers. Taken together they ensure that MPC will retain a large share of its current market, and with a large market share, significant market power.

Q. How great a market share would it take for MPC to retain market power?

A. MPC's own witness Shepherd testified in his prefiled testimony at WGS-12, lines 7-9, that a market share above 20 percent would "begin to provide significant market power."

Q. What would you expect MP Energy's market share to be under MPC's proposed restructuring plan?

A. If MPC's proposal is adopted intact, I would be surprised if MP Energy did not retain an 80-90 percent or greater share of the retail customers, and over (perhaps well over) 50 percent of the retail sales, within MPC's traditional service territory. The factors discussed above will ensure that few if any customers other than the very largest ones will be able to see any financial benefits from selecting another supplier, at least through the 4-year transition period. Even after the transition period when financial incentives to switching are at least possible, the combination of traditional customer loyalty, MPC control over customer information, the design of the Distribution Service Charge, the allocation of customers who do not choose, and the barriers to competition placed by MPC control over billing and metering will be a major deterrent to competitors winning away significant portions of MPC's market.

Q. What would be the result of MP Energy market shares in this range?

A. There would be a great incentive to charge prices above competitive levels, and to use complex, discriminatory pricing to extract higher revenues from customers while fending off competitors. There would be a reduced incentive to be as efficient as possible or to innovate in new product development.

Q. How does market power allow a firm to raise prices and make higher profits?

A. In a perfectly competitive market no participant has any market power, the price is set by supply and demand, and each firm faces a flat, or "perfectly elastic" demand curve. Any firm that tries to raise its price above the market price will immediately lose all its customers to competing firms.

To the extent a firm gains market power the demand curve for its sales becomes relatively more inelastic, until a firm with a monopoly faces the market demand curve. Once there is market power, a firm can choose a profit-maximizing pricing strategy involving raising prices somewhat above the competitive level, to a level that balances the revenue loss or gain the firm will see given the demand curve it faces. The greater the market power, the less its sales will go down when it raises its price. In a market with a few competitors there will be a tendency for the competitors to retaliate against efforts to increase market share, until a comfortable arrangement is reached with competitors relatively satisfied (at consumers' expense).

Q. How does this analysis apply to MPC's likely market power?

A. In a vigorously competitive market, using MPC's estimate of 17.87 mills for the market value of energy, MP Energy would be unable to charge any more than that because competitors would immediately capture most or all of their customers. With significant market power, MP Energy would face a relatively inelastic demand and would maximize its profits by charging higher prices, while losing sales only to the extent indicated by the price elasticity of their market demand; as an unregulated entity, MP Energy could be able to earn significantly greater profits for shareholders. There would be no restraint by competition or regulation to temper the company's incentive to exploit this possibility.

If there were a level playing field for energy, MPC would have to worry about the pricing strategies of its competitors, but under the proposed levels of CTC charges and MPC's estimated value of the energy credit, I believe it is unlikely that any competitor would be able to retaliate.

Q. Would this result meet the goals of restructuring?

A. No, it would not. The intent of restructuring is to bring the benefits of competition to consumers. It presupposes that vigorous competition will serve as a brake on monopolistic price-setting behavior. Without competition, consumers would be at the mercy of a deregulated monopoly.

Q. Do you think MPC's proposed restructuring plan, as laid out in its direct testimony and its supplemental testimony, provides a basis for meeting the goals of restructuring and the goals you have recommended for the Commission?

A. No, I do not. MPC's plan, as presented in the testimony we have seen thus far in this docket, aims at maximizing the interest of MPC. It fails to provide a level playing field that will facilitate the development of vigorous competition; instead it proposes to retain significant advantages for MPC's unregulated activities at the expense of competitors.

Q. Please explain how MPC's proposed restructuring plan would inhibit competition.

A. I have previously listed a number of reasons why MPC's proposed plan will inhibit competition. I will now address several of these in greater detail, beginning with MPC's

inadequate separation of regulated and unregulated functions, followed by its overestimation of stranded costs, and hence, CTC charges; the proposed Delivery Service Charge; and the proposed allocation of customers who do not explicitly choose a supplier. DEQ witness Alan Davis will also address a number of these issues, including some aspects of functional separation, and MPC's proposed pilot programs and customer education programs.

Functional Separation and Competition

Q. Why will MPC's proposed separation of supply and services inhibit the development of vigorous competition?

A. The major reason is that MPC does not properly separate activities that are appropriately provided by a regulated monopoly, such as the provision of transmission and distribution wires, from those that are appropriately subject to competition and choice.

Q. How does MPC's proposal match the requirements of SB 390 for functional separation?

A. SB 390 requires that MPC functionally separate its energy supply, transmission wires, distribution wires, regulated energy services, and unregulated energy services. Section 69-8-204, MCA. By contrast, MPC proposes only to separate its energy supply from its wires and energy services.

MPC proposes to separate its energy supply functions ("MP Energy") from the transmission and distribution function ("MPC Energy Services Division"), as required by FERC. However, MPC does not propose to separate transmission from distribution, which is required by SB 390 and which makes good sense because they are regulated by different agencies. Further, MPC does not propose to separate its regulated retail energy services from the distribution function.

However, the biggest problem with MPC's proposal lies in where it proposes to draw the line between the regulated company and unregulated energy services. MPC proposes that the regulated distribution provide many services that could easily be provided by competitive entities. For example, MPC's restructuring plan proposes to retain control of metering and billing under the distribution function. Further, MPC proposes that the distribution function will continue providing DSM to its customers on a regulated basis. Provision of these services by MPC will increase its lock on its customer base, and metering may provide a link to future markets in unregulated non-energy services (such as electronic home management, burglar alarm services, and information and telecommunications services). This may be good business practice for MPC but it is clearly bad public policy because it discourages the development of vigorous competition. Without such competition restructuring cannot provide its promised benefits to consumers.

Q. Why is the lack of separation a problem?

A. In a restructured market there will be many competitors offering to supply energy and other services to retail customers, over the regulated transmission and distribution wires owned by MPC. One of these competitors will be MP Energy. For competition to work there must be a level playing field among competitors. Under MPC's proposal, any competitor will not only have to go through MPC's wires, but also through MPC's meter and billing system.

MPC's name and logo will be on the bill, the customer will have to make out his check to MPC, and all communication will be through MPC. This cannot help but provide a differential in customer brand name recognition and customer loyalty in favor of MPC as the energy supplier.

Further, control over the meter and bill by MPC means control over customer information and customer contact. This will provide a valuable inside connection for MP Energy and a significant barrier for other competitors, particularly if MPC uses privacy issues as a screen for refusing to provide access to this information for competitors.

Q. Are there other problems?

A. Yes. It is likely that the new generation of smart meters that will become widespread with restructuring will facilitate the development of a wide range of new products that can be marketed to customers, in such areas as communication, information, entertainment, home management and alarm services. These almost certainly will be unregulated products, provided by MPC through MP Energy or another unregulated entity, yet MPC proposes that the regulated distribution function keep a monopoly on the meters that will be the key to the market. Under MPC's proposal independent competitors would be frozen out of the markets for these new services; customers would have no choice but to pay for the meters to be provided by MPC; and MPC's unregulated subsidiary would reap the benefit of providing unregulated services through a monopoly hold on its market.

Q. Is there any reason why MPC should provide the meters?

A. Not in general. A competitor should be able to provide his own metering along with supplying energy or other services. Further, it should be possible for a competitor to supply metering and billing even to customers who propose to continue purchasing energy from MP Energy.

MPC Energy Services Division will be providing the wires service and they must be paid for the use of these services. However MPC proposes to bill the energy supplier, rather than the customer, for wires service (and MPC assumes that such charges will be passed along to the end user). The financial implications to MPC Energy Services Division should be the same whether it is paid by the energy supplier and the supplier bills the customer, or it serves as the billing intermediary itself.

MPC might argue that it needs the metering in place for system control, that is, to be able to balance loads and resources. However, the metering necessary for load balancing is at the substation level where real-time metering is already in place, not at the customer level.

Q. Does MPC need to control metering for reliability?

A. No, the customer meters don't provide any real-time information that would be useful for monitoring system availability or reliability.

Q. What should be involved in functional separation?

A. There are two principles that should govern functional separation. First, to ensure that regulated monopolies cannot operate to advantage their unregulated affiliates, all competitive activities should be separated from regulated activities. Second, only those activities that, by their nature, cannot be provided by competitive markets, should be regulated. Those activities whose markets are not at least workably competitive should be

separately regulated on a temporary basis until effective competition can develop; they should be defaulted to long term or permanent regulatory status by remaining incorporated within the regulated MP Energy Services Division.

Q. How has MPC responded to DEQ/NPPC's analysis of SB 390's requirement for full functional separation of customer services, including metering and billing?

A. DEQ/NPPC raised this issue in our Preliminary Comments on the Completeness of MPC's Plan, dated July 22, 1997. MPC's response to these comments, "The Montana Power Company's Response to LCG and DEQ Comments," dated September 22, 1997, contained the following statement:

MPC will not emasculate its Services Division based upon imagined fears and predictions.

MPC has consistently refused thus far to budge from this position in this docket, and has taken the position that full functional separation is neither necessary nor required by law. However, DEQ/NPPC does not agree that its recommendations are based on "imagined fears and predictions" and reiterates that full functional separation is explicitly required by SB 390.

Q. How do you recommend the Commission act with regard to functional separation and the establishment of vigorous competition in retail service?

A. I recommend that the Commission take a clear position that restructuring must lead to vigorous competition in retail markets, and that in the absence of the structural changes necessary to achieve vigorous competition, MPC cannot expect to recover any stranded costs. As other witnesses elaborate, there was a clear "quid pro quo" involved in SB 390. MPC would get a deregulated energy supply function and the opportunity to recover stranded costs, and consumers would get the benefits of a competitive retail marketplace for both energy supply and energy services. MPC's refusal to allow competition in key retail energy services will impede the development of competitive markets. The Commission should not approve MPC's Transition Plan, nor any stranded costs recovery, until the plan provides for full separation of MPC's regulated wires business from all of its competitive energy services.

Further, I recommend that the Commission direct MPC to functionally separate its activities as follows:

- 1. The company's unregulated wholesale power supply operations should appropriately be separated into MP Energy. Once the transition period ends the Commission should no longer be concerned with the operations of this division.**
- 2. Transmission and distributions wires service should be separated, probably into two separate divisions ("MPC Transco" and "MPC Disco"), since transmission wires will be regulated by FERC and most likely turned over to IndeGO, if that company succeeds in establishing itself, or into another independent grid operator or transmission company. Distribution wires will continue to be regulated by the Montana PSC, and this regulation will be easiest and cleanest if the distribution wires are functionally separated and have their costs unbundled.**
- 3. The Commission should clearly define the minimum bundle of customer services it believes should continue to be provided on a monopoly basis by MPC, and subject**

to continued regulation.

4. All customer services beyond this minimum bundle, existing or new, should be provided on a competitive basis by MPC. At a minimum, all energy services that MPC offers to provide on a competitive basis in California should be provided on a competitive basis here. Such services should include metering and billing; DSM; customer energy usage consulting; the provision of all ancillary services that do not have to be provided by the wires operations; and such new services as marketing electrical equipment and appliances and meter-related services such as energy management, burglar alarms, information and communication, Internet and cable tv. It might be preferable for these services to be provided by a division independent of MP Energy, but that presumably would be up to the decision of MPC management.

5. There must be a clear firewall and Code of Conduct, as required by SB 390, governing information flows between the regulated transmission and distribution functions and each unregulated entity, and each should provide services equally to MPC's Energy Services Division and other competitors.

Stranded costs

Q. What is the issue you want to address with regard to stranded costs?

A. Stranded costs are an important issue for establishing vigorous competition because by collecting them through CTC charges MPC is creating a barrier to competitors. Together with the other barriers that will be created by MPC's proposal, MPC's proposed CTC charges will greatly reduce the likelihood that there will be vigorous competition to protect consumers from abuse of market power by MPC and its unregulated affiliates and divisions.

MPC proposed to collect its stranded costs through non-bypassable Competitive Transition Charges (CTCs). To do this it must partition its costs into those that can be supported by the market and those that are above the market and hence strandable.

MPC has a clear incentive to understate the market value of its plants and to overstate its stranded costs. If the line between market value and above market costs can be drawn at too low a level, it will have the effect of shifting costs from the unregulated supply company to the transition charges. MP Energy will be able to write down its revenue needs to a level corresponding to this line, and will be able to compete at a lower level of cost than other competitors. Customers will be stuck paying non-bypassable charges for the excessive measure of stranded costs. Competitors will be faced with an extra barrier, perhaps an impossible barrier, they will have surmount in order to present an attractive package.

Q. How are MPC's CTC charges presented?

A. MPC proposes three classes of CTC charges. The first, CTC-HT, are the stranded costs associated with above-market costs of MPC's hydro and thermal generating resources. The second, CTC-QF, are associated with the above market portion of MPC's Qualifying Facility (QF) and other power purchase contracts. The third, CTC-RA, is designed to collect MPC's regulatory assets, including such things as past DSM cost and deferred tax liabilities.

Q. What is your testimony with regard to MPC's proposed measure of stranded hydro and thermal generation stranded costs?

A. There are two issues I would like to address. First, I believe MPC's method for measuring stranded costs is not consistent with the requirements of SB 390. Second, I believe MPC's estimate of the market value of power from its generation for the transition period is too low.

Q. What is your testimony with regard to MPC's method for measuring stranded hydro and thermal generating costs ?

A. MPC has selected a measure of stranded costs for its generating resources that advantages itself at the expense of customers. It has done this in two ways. First, under the banner of "only" recovering stranded costs for its hydro and thermal resources for 4 years, MPC proposes to collect over \$160 million from non-bypassable wires charges during the transition period, and then "assume the risk" on the plants. However, prices in the near term are at historic lows due to abundant water conditions, excess supply of generation in the region, and changes in the markets. Most observers expect prices to rise to the marginal cost of power from adding a new resource as soon as rising demands eliminate the surplus. If this is the case, customers would pay MPC's estimated above-market costs for the near term, and later, after the transition and when markets recover, MPC would reap the benefits of higher prices and profits without regulatory restraint or oversight.

Q. Does MPC's proposed measure satisfy the requirements of SB 390?

A. MPC's proposed measure is inconsistent with the requirements of SB 390. The method for estimation is at odds with all the methods described as acceptable.

Two paragraphs in SB 390 control the estimation of stranded costs.

Section 69-8-211(1)(c), MCA, states:

(1) Subject to the provisions of this section, the commission shall allow recovery of the following categories of transition costs:

...

(c) the unmitigable transition costs related to public utility-owned generation and other power purchase contracts, except that recovery of those costs is limited to the amount accruing during the first 4 years after the commission enters an order pursuant to 69-8-202 (3); ...

Section 69-8-211(2)(b), MCA, states:

(2) Transition costs as determined by the commission upon an affirmative showing by a public utility must meet the following requirements:

...

(b) The value of all generation-related assets and liabilities and electricity supply costs must be reasonably demonstrable and must be considered on a net basis, and methods for determining value must include but are not limited to:

(i) estimating future market values of electricity and ancillary services provided by the assets;

(ii) appraisal by independent third-party professionals; or

(iii) a competitive bid sale.

MPC has chosen to interpret 211(1)(c) to mean it can recover the year-by-year above-market costs during the transition period and to ignore any future market gains after that time. MPC has also chosen to ignore 211(2)(b) , and as a result MPC's estimate of stranded costs is inconsistent with all of the methods listed in 211(2)(b) . It is clear that all of the methods described in 211(2)(b) are different approaches to get at the market value of the generating assets, given the stream of income they are likely to generate over their useful lives (netting any short-term losses and long-term gains against each other). By contrast MPC proposes to count only the 4-year transition period stream of costs and revenues. The resulting estimate of stranded costs is a sharply truncated portion of the whole picture that is required by section 211(2)(b) . Perhaps incidentally, it is an estimate that clearly benefits MPC in the short term at the expense of its captive customers by forcing them to pay CTC charges, and then further benefits MPC in the long term by allowing it to profit when prices rise through normal market forces to levels above the (no longer relevant) book values on the plants.

Q. Are these two sections in the Act inconsistent with each other?

A. No. Section 69-8-211(1)(c), MCA, places an upper limit on how much stranded costs can be collected for generating resources and purchase contracts. If the overall above-market cost exceeds that of the first four years, MPC is limited to collecting the amount accruing during that 4-year period. If the overall amount of above market cost is less than the amount of stranded costs accruing during the first 4 years, MPC can collect that lower value. If the overall generating resource stranded costs are negative (that is, the plant produces stranded benefits rather than costs), MPC must net those benefits against its other categories of stranded cost (the QF stranded costs and the regulatory asset stranded costs), or against its retail rates.

Q. Please explain your comments about MPC's estimate of the transition period market value of power.

A. I believe that MPC has further exaggerated its stranded costs by selecting an estimate for the near term market that is too low. MPC has provided an estimate of the value of energy for the four year transition period that appears to be significantly lower than other credible estimates, for example, those provided by the Northwest Power Planning Council and by the Energy Information Administration. This is due in part to the fact that MPC's estimate provides a value only for energy with a 100 percent load factor, whereas the plants are dispatchable and are routinely used to meet the actual shaped loads of MPC's customers.

Thus, MPC estimates near term price at approximately 17.9 mills, based upon responses it received to a solicitation for bids to purchase power. MPC based its estimate of the value of the power on the bids it received from a competitive solicitation for a purchase of energy for the 4-year period at a 100 percent load factor. This does not match the capability of the plants, and the resulting bids do not match the value of the power for the plants over the 4-year period in question. With regard to the plant capability, they cannot run at a 100 percent load factor, but they are dispatchable to meet MPC's or the buyer's load shape. A 100 percent load shape purchase would not enable a purchasing utility to run its remaining plants as efficiently as a purchase that matched his load shape, and therefore is not as valuable to it. As a result, the bids MPC received are not indicative of the value of the plants, but are too low.

By contrast, NPPC estimates the near term price in MPC's range only with very high hydro levels, not with median water conditions. The Department of Energy, Energy Information Administration's (EIA's) competitive model forecasts energy prices in the 33-34 mill range but they have not represented the Pacific Northwest surplus very well in their model; a recent estimate from the EIA was that correctly modeling the surplus would reduce wholesale power values to around 25 mills. Power from new gas turbines is currently estimated by NPPC in the range of 25-27 mills.

Q. What is your testimony with regard to stranded QF costs?

A. SB 390 allows MPC full recovery of unmitigable stranded QF contract costs. However, section 12(2)(a) of SB 390 requires that:

(2)(a) Transition costs must reflect all reasonable mitigation by the public utility, including but not limited to good faith efforts to renegotiate contracts, buying out or buying down contracts, and refinancing through transition bonds.

Section 69-8-211(2)(a), MCA. I believe that the burden of proof is on MPC to demonstrate that these costs are unmitigable. They have not done this. MPC reports on the results of some desultory conversations with QFs and reports that discussions are continuing.

Q. Do you have a position on Regulatory Assets stranded costs?

A. I have no position on Regulatory Asset stranded costs at this time.

Q. Please summarize your overall conclusions with respect to stranded costs?

A. SB 390 requires that for stranded hydro and thermal generating costs to be recoverable they must be "reasonably demonstrable and must be considered on a net basis, and methods for determining value must include but are not limited to:

- (i) estimating future market values of electricity and ancillary services provided by the assets;
- (ii) appraisal by independent third-party professionals; or
- (iii) a competitive bid sale."

Section 69-8-211(2)(b), MCA. MPC's proposed hydro and thermal stranded cost estimates do not meet these requirements. They are not reasonably demonstrable, they are not considered on a net basis over the useful life of the resources, and they are not consistent with the methods listed.

Further, I believe MPC's estimate of the value of the output of its generating plants for the first four years is too low because it ignores the value of dispatchability.

In addition, MPC has offered an estimate of its stranded QF costs that ignores the requirement of SB 390 that such costs reflect all reasonable mitigation.

As a consequence, MPC has not met the tests set by SB 390 of providing reasonably demonstrable evidence of its stranded costs. MPC has presented no credible evidence as to the value of unmitigable stranded QF costs that could be approved by the Commission in

accordance with SB 390, and no evidence that stranded hydro and thermal generating costs are not negative and therefore do not have to be netted against any positive stranded QF costs and stranded Regulatory Asset costs.

Q. What is your recommendation to the Commission on stranded costs?

A. I recommend that the Commission find that MPC has not met the standard of reasonably demonstrable, net stranded costs that reflect all reasonable mitigation, and I recommend that the Commission reject MPC's stranded cost recovery proposal.

Further, I recommend that the Commission not approve any stranded cost recovery, until such time that MPC not only cures the defects in its methods and calculations, but also until MPC modifies its Transition Plan in accordance with my other recommendations in this testimony to ensure that there is a fully level playing field that will encourage, not impede, the development of workable and vigorous competition.

Distribution Charges and the Delivery Service Charge

Q. What is the issue with regard to the distribution charges?

A. Part of the functional separation essential to making competition work is an unbundling of costs and tariffs. FERC has required all transmission owning utilities to functionally separate their transmission businesses, to adopt codes of conduct that govern information flows between the transmission business and the other parts of the utility, and to file a non-discriminatory, open access, comparability tariff that governs access to and use of their wires by their own generating entity as well as other entities. SB 390 implements similar requirements for the distribution system. Section 69-8-208(1)(a), MCA, requires that:

(1) A public utility's distribution services provider shall:

(a) file tariffs that make distribution facilities available to all electricity suppliers, transmission services providers, and customers on a nondiscriminatory and comparable basis;

MPC asserts that this requirement is fulfilled by its Market Supply Service (MSS) Tariff. However, the MSS tariff does not govern the use of the distribution system. It does not make the distribution facilities available to all electricity suppliers, transmission services providers, and customers on a nondiscriminatory and comparable basis. It simply does not apply to electricity suppliers and transmission service providers. It applies only to customers, and only to those customers who choose another supplier. It is a device for charging customers who choose another supplier a non-cost based residual charge to ensure that they do not benefit from a bill reduction. This charge, the Delivery Service Charge (DSC), covers the costs of a variety of functions besides the distribution system.

Q. What is the Delivery Service Charge and how is it calculated?

A. The Delivery Service Charge is part of MPC's proposed MSS Tariff, which applies to customers who choose another supplier or who choose to purchase unbundled market

priced power from MPC. Under this tariff customers will be charged a rate that equals the sum of the CTC charges, any other charges such as the Universal System Benefits Charge (USBC) that are approved by the Commission, the Transmission charge as filed in MPC's FERC transmission tariff, ancillary service charges, and the Delivery Service Charge (DSC). The DSC, in turn, equals one-twelfth the sum of what the customer's annual bill would be under a full bundled rate, less the sum of CTC charges, USBC, transmission charges, ancillary service charges, and electricity supply charges. The DSC is a non-bypassable flat charge per month calculated separately for each customer.

MPC states that the DSC is designed to avoid losing low distribution cost customers and being stuck with high cost ones, that would be the case with a uniform cost-based distribution charge. However the DSC has the incidental effect of ensuring that regardless of how low MPC estimates the market value of electricity, or how low the Commission sets CTC charges, the customer's monthly bill will not change if the customer chooses another supplier.

Q. What is the issue with regard to MPC's proposed Delivery Service Charge?

A. The Delivery Service Charge is an issue in part because it adds to the barriers to competition. The DSC is a non-bypassable bundled charge that covers a variety of costs associated not only with the delivery of power, but with services that could be provided by competitive entities. Further, MPC proposes to calculate it as a residual cost, rather than to explicitly calculate the cost of providing delivery service. It is calculated separately for each customer, designed to reduce the incentive of customers to leave the MPC system. MPC's proposed Delivery Service Charge will further inhibit the development of vigorous competition and ensure that there is no brake on MPC's ability to exercise market power.

A major principle of ratemaking is that rates must reflect costs. MPC makes no pretense that the delivery service charge reflects the costs of providing distribution service. Rather it is a residual, the previous rate paid by the customer less the sum of the energy credit (17.87 mills, MPC estimate), the transmission charge, and the CTC charges. Further, the delivery service charge masks the costs of providing several different types of service. It covers the costs of delivering power from the point it leaves the bulk transmission system to the customer's meter. It covers metering and billing costs, and it covers a variety of other costs such as the cost of responding to complaints and outages, customer energy queries or requests for assistance in planning on-premises electricity using facilities, and others. By lumping all these costs together under the Delivery Service Charge, MPC has avoided providing information required by SB 390 such as establishment of a distribution tariff and the functional separation of distribution from regulated energy services and unregulated energy services.

Q. Has this concept been proposed or approved in other states?

A. DEQ/NPPC asked MPC to provide examples of other utilities that have proposed similarly constructed residual charges designed to hold the customer's bill unchanged after unbundling other charges, that have received regulatory scrutiny in other jurisdictions (Data Request DEQ 1-011). MPC was unable to provide any such examples. MPC's proposed Delivery Service Charge is an untested concept that violates the normally accepted principles of ratemaking and serves as an additional barrier to the development of vigorous competition in Montana.

Q. What do you recommend the Commission do with regard to the Delivery Service Charge?

A. I recommend the Commission reject MPC's proposed Delivery Service Charge as written, and direct MPC to redesign its retail charges in the following way:

- 1. Functionally separate the distribution facilities and create a distribution tariff that will appear as a separate billing item.**
- 2. Create a separate cost-based billing item for those energy services that the Commission determines are core regulated services.**
- 3. Create a separate cost-based billing item for metering and billing costs.**
- 4. Create a separate billing charge for all other energy services that are not provided on a non-competitive basis, and allow customers to choose whether to buy these services from MPC, from another supplier, or to forego them.**

Allocation of customers who do not choose a supplier

Q. What is the issue with MPC's proposal for allocating customers who do not choose a supplier?

A. MPC's proposal will further increase MPC's ability to retain its customers after the transition period when all customers should have choice. The greater MPC's hold on its customers, the greater will be its market power and its ability to exercise that market power by using monopolistic pricing methods,

Q. Please explain your comment.

A. MPC proposes that customers be given a 3-month window after the start of choice to select an energy supplier. At the end of that time, those who have not chosen a supplier will be allocated according to the proportions of those that have. For example, if at the end of the 3-month period, a total of 20 percent of MPC's customers have selected a supplier, with 17 percent choosing MP Energy, 2 percent choosing Pacificorp and 1 percent choosing Enron, then the remaining 80 percent would be allocated the same way. Sixty-eight percent would be allocated to MP Energy, 8 percent to Pacificorp, and 4 percent to Enron.

MPC witness James Falvey states on page JMF-14 of his direct testimony:

This is not to argue that the movement from a regulated supply market to a completely competitive supply market will occur instantaneously. Competition will take time to emerge and mature as both suppliers and customers learn the process.

Most customers probably will make no immediate change when offered the ability to choose their energy supplier. It will take a while for them to become used to the idea of choosing, and to sort out the claims and counterclaims of utilities, suppliers and aggregators who may be clamoring for their business. Of those that do sign up, it is likely that the great majority will simply opt for remaining with what looks like their traditional supplier. Whether out of loyalty to and recognition of the years of reliable service they have gotten from their long-term relationship with MPC, or in response to the marketing blitz already underway to build such a relationship, or simply out of fear of the unknown, most will select MPC.

Q. Why is this a problem?

A. It is a problem because it goes to the heart of making restructuring work: if we remove the restraints of regulation on MPC's generating facilities, there must be vigorous competition to restrain the market power. Otherwise customers will be at the mercy of an unregulated monopolist, and they are likely to pay heavily for it.

If most customers do not choose, but those who do mostly opt for sticking with MPC, and we simply allocate the remainder along the same lines, we are guaranteeing MP Energy the lion's share of the market and significant market power. Since we are giving up the ability to regulate MP Energy and are freeing it to make unregulated profits, we should not in any way enhance its ability to abuse its market position. That is just what we will be doing if we accept MPC's proposal.

Q. Are you suggesting that MPC customers be denied the right to choose MPC, or that MP Energy be denied the right to compete?

A. No, not at all. It certainly is possible that MPC (or some other supplier) might out-compete all other suppliers and control the bulk of the market. If that happens we will have to deal with it as best we can given the tools of anti-trust legislation. However, MPC's Transition Plan would set up the process to give MPC control over the bulk of its market without even having to compete to get it. This is inappropriate for restructuring and certainly inappropriate for the Commission to approve.

Q. What do you recommend instead?

A. I suggest that the market be allowed to develop, and that customers be allowed to get used to the idea of choice, for a longer period, perhaps one year. At the end of that time, MPC should issue a competitive bid solicitation for a supplier to serve the residual group of customers who have not chosen a supplier.

Q. Does this conclude your testimony?

A. Yes it does.