

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF SOUTH DAKOTA**

**In the Matter of the Complaint by Oak
Tree Energy LLC against
NorthWestern Energy for Refusing to
Enter into a Purchase Power
Agreement**

Docket No. EL11-006

**Commission Staff's Answer
To Oak Tree's Motion For Partial
Reconsideration Of Interim Order**

I. INTRODUCTION

On May 15, 2012, the Commission released its *Interim Order; Order For and Notice of Further Hearing* (Order) in the above-captioned Commission docket. This Order provided partial resolution of issues presented in the docket and served as a request to the parties for additional information on issues unable to be resolved on the record provided. On May 29, 2012, Oak Tree Energy, LLC (Oak Tree) filed *Oak Tree Energy, LLC's Motion For Partial Reconsideration Of Interim Order* (Oak Tree's Motion or Motion). In its Motion, Oak Tree asks the Commission to reconsider its decision with respect to: (1) the use of the hybrid method identified by NorthWestern Energy (NWE) in this proceeding to determine the appropriate avoided cost; (2) the use of current market conditions and projections to determine the proper natural gas inputs and proper electric market rates; and (3) the use of Lands Energy's carbon emission cost estimate of \$5/ton starting in 2015, increasing to \$10/ton starting in 2020, and \$15/ton starting in 2025. (Oak Tree Mot., 1 - 2).

Pursuant to the Administrative Rules of South Dakota, Section 20:10:01:30.02, Commission Staff submits this Answer to Oak Tree's Motion.

II. ARGUMENT

For the reasons provided below, Commission Staff (1) opposes Oak Tree's request that the Commission reconsider the use of the hybrid method as the appropriate avoided

cost calculation methodology to determine NWE's avoided cost rate; (2) supports Oak Tree's request that the Commission reconsider the use of current market conditions and projections in determining the appropriate natural gas inputs and electric market rate input; and (3) supports Oak Tree's request to reconsider the use of Lands Energy's carbon price estimate as the appropriate carbon price estimate used in determining NWE's avoided cost rate.

A. USE OF THE HYBRID METHOD IS CONSISTENT WITH 16 U.S.C. 824a-3 AND 18 C.F.R. §§ 292.303 AND 292.304 AND IS THE APPROPRIATE CALCULATION METHOD TO DETERMINE NWE'S AVOIDED COST RATES AS IT REFLECTS THE TRUE NATURE OF NWE'S SYSTEM OPERATIONS AND THE TRUE INCREMENTAL COSTS ON WHICH TO BASE AVOIDED COST RATES.

In its Motion, Oak Tree asserts the Commission's decision to adopt NWE's hybrid avoided cost methodology is inconsistent with the principle of avoided cost established in Section 210 of the Public Utility Regulatory Policies Act of 1978, 16 U.S.C. §824a-3(b)(PURPA). Oak Tree argues use of the hybrid method violates PURPA in that it: (1) does not appropriately calculate NWE's avoided cost; and (2) it is unduly discriminatory in that Oak Tree receives avoided cost pricing based on NWE's coal resources during low load hours rather than the value of the market, but does not realize the benefit of NWE's peaking units in the hours when market prices are lower than the cost of operating NWE's peaking units.

Oak Tree argues by assigning the market value during high load hours when NWE's resources are more expensive, but depriving Oak Tree the market value during low load hours when NWE's resources cost incrementally less to operate than market, is discriminatory. Oak Tree believes the Commission must either rely upon market energy estimates or incremental costs of operating NWE's internal generation exclusively and blending the two cost components is inconsistent with PURPA.

Commission Staff disagrees with Oak Tree's assertion that the hybrid method is inconsistent with PURPA. The hybrid method is the only appropriate avoided cost calculation methodology to use under the circumstances. This is due to NWE's status in

South Dakota as a vertically integrated utility which predominantly relies on its own internal generation. The Commission cannot base an avoided cost rate exclusively on market estimates or incremental costs of operating NWE's internal resources, as this does not reflect the true nature of NWE's South Dakota systems and the costs associated with operating that system. In addition, strict reliance upon either of the cost components does not give proper effect to the requirements of PURPA.

PURPA requires an electric utility to purchase all electric energy made available by cogenerators at rates that,

- (a) Are just and reasonable to electric consumers,
- (b) Do not discriminate against QFs, and
- (c) **Do not exceed the incremental cost to the electric utility of alternative electric energy.** (emphasis added).

"The incremental cost to the utility means **the amount it would cost the utility to generate or purchase the electric energy but for the purchase from the cogenerator.**" (emphasis added) *Public Service Co. of Oklahoma v. State ex rel. Oklahoma Corp. Com'n*, 115 P.3d 861, 870 -871 (Okla.,2005) Also, as pointed out by Oak Tree in its Motion, 18 CFR 292.304(b)(2) "requires a utility to purchase electricity from a qualifying facility at a rate equal to the utility's full avoided cost. The utility's full avoided cost is '**the cost to the electric utility of the electric energy** which, but for the purchase from such cogenerator or small power producer, **such utility would generate or purchase from another source.**'" (emphasis added). *American Paper Institute, Inc. v. American Elec. Power Service Corp.*, 461 U.S. 402, 406, 103 S.Ct. 1921, 1924 (U.S.Dist.Col.,1983)(internal citations omitted). As such, "the term full 'avoided costs' used in the regulations is the equivalent of the term 'incremental cost of alternative electric energy' used in § 210(d) of PURPA." *Id.*

Adhering to the plain language of PURPA in setting NWE's avoided cost rate, requires this Commission to set an avoided cost rate equal to the amount NWE would need to generate or purchase electric energy if it does not take the output of Oak Tree. Contrary to Oak Tree's assertions, the only way to properly implement this requirement is by applying the hybrid method to determine NWE's avoided cost rate. If the Commission relies on strict application of the market estimates method and applies the

low range of market estimates provided by Oak Tree during hours when NWE is long on energy, this does not reflect the actual costs NWE would incur if it were to **generate or purchase from another source**.

When NWE is Long on Energy: The Incremental Cost of NWE's Internal Baseload Generation Is the Appropriate Measure of Avoided Cost.

In the hours when NWE is long on energy and internal generation is sufficient to satisfy all load requirements, the true incremental cost is the 'variable incremental cost' of NWE's baseload generation. In reality, during these hours, NWE would not purchase market energy in the absence of receiving the Oak Tree output. The proper measure of cost under PURPA is the cost NWE will realize to generate or purchase electric energy if it does not take the output of Oak Tree. At times when NWE is long on energy, if it does not receive energy from Oak Tree to satisfy load requirements, it will satisfy these load requirements with its existing internal generation. As such, at times when NWE is long on energy, the spot market price is not the appropriate measure of costs as these units will not be the actual units NWE would use to supplement any output it would receive from Oak Tree.

When NWE is Short on Energy: The Incremental Cost of Market Energy is the Appropriate Measure of Avoided Cost.

In hours when NWE is short on energy and internal generation is insufficient to satisfy all load requirements, the true incremental cost is market energy, not NWE's peaking units. Due to the overabundance of available energy in the upper Midwest region, it is more cost efficient for NWE to meet excess energy needs with market purchases as opposed to operating its expensive peaking units. In addition, there has been evidence presented NWE has not run its peaking units in approximately four years due to the favorable market prices. During hours when NWE is short on energy, it would not operate its peaking units to supplement energy it would otherwise receive from Oak Tree. Again, in reality, it would supplement these energy requirements with market purchases. Therefore, the incremental cost associated with NWE's peaking units is not the appropriate measure of incremental costs during these hours. At times when NWE

is short on energy, market prices are the appropriate measure of incremental costs as these are the units NWE will purchase to supplement any shortfall realized in the absence of Oak Tree.

B. NATURAL GAS INPUTS AND ELECTRIC MARKET RATE INPUTS SHOULD BE BASED ON MARKET CONDITIONS AND PROJECTIONS AS THEY EXISTED ON THE DATE OAK TREE ESTABLISHED A LEGALLY ENFORCEABLE OBLIGATION, FEBRUARY 25, 2011.

The Commission has determined Oak Tree established a legally enforceable obligation (LEO) on February 25, 2011, when Oak Tree provided NWE with a letter, along with an executed PPA, stating it was establishing an LEO. Pursuant to 18 C.F.R § 292.304(d), a QF shall have the option to either:

- (1) *To provide energy as the qualifying facility determines such energy to be available for such purchases, in which case the rates for such purchases shall be based on the purchasing utility's avoided costs calculated at the time of delivery; or*
- (2) *To provide energy or capacity pursuant to a legally enforceable obligation for the delivery of energy or capacity over a specified term, in which case the rates for such purchases shall, at the option of the qualifying facility exercised prior to the beginning of the specified term, be based on either:*
 - (i) *The avoided costs calculated at the time of delivery; or*
 - (ii) ***The avoided costs calculated at the time the obligation is incurred. (emphasis added).***

Commission Staff believes the language contained in part (2)(ii) of this rule requires an avoided cost rate be based on information available when the LEO is created. When a qualifying facility elects to provide energy and capacity pursuant to an LEO, PURPA states the avoided cost will be calculated as of that date. In this case, the LEO was created on February 25, 2011. Any calculation to be performed must be performed as of that date. Calculating an avoided cost rate according to the LEO date requires looking back to information available at the LEO date. To establish an avoided cost rate based on current market information will in effect establish an avoided cost as of the most recent date for which adequate information is available to the parties to rely

upon. As such, Staff supports Oak Tree's request to reconsider this portion of the Commission's Order.

C. LANDS ENERGY'S CARBON EMISSIONS COST ESTIMATES SHOULD NOT BE USED AS THEY DO NOT APPEAR TO BE BASED ON ANY EVIDENCE.

Commission Staff supports Oak Tree in its request to reconsider the carbon cost estimates to be included in the calculation of Oak Tree's avoided cost rates. The carbon cost estimate provided by Lands Energy does not carry sufficient evidentiary support to be used in this proceeding. From the testimony presented by NWE's witness Mr. Steve Lewis, it is unclear whether the carbon cost estimate provided by Lands Energy, \$5/ton starting in 2015 and shifting to \$10/ton starting in 2020 and rising to \$15/ton in 2025, is based on potential legislation or other credible evidence. No evidence was presented in the record to support Mr. Lewis's carbon price estimate.

Staff suggests using a carbon price projection guided by potential legislation and discounted based upon assumed probability of that legislation becoming law. Although to what degree the potential legislation should be discounted is a matter of judgment, it is not unlike the practice utilized by utilities for long-term planning. When a utility creates a long-term resource plan, using long-term forecasting, they typically look at a number of scenarios, with varying sensitivities to determine how those variables impact their decision. In the end, the utility uses the outcome of those scenarios as well as the assumed probability of their occurrence to guide their decision.

In this case, Oak Tree has provided the Commission with a carbon price estimate based on actual proposed legislation. If the Commission relies on Oak Tree's estimate without discounting, Staff feels this produces a price unreasonably high due to the very uncertain nature of any carbon legislation passing in the near future. If the Commission adopts the carbon price estimate offered by Lands Energy, Staff feels the estimate is unreliable without necessary supporting data. As such, Staff feels it is appropriate for the Commission to exercise its judgment to establish a carbon price projection guided by potential legislation and discounted based upon the assumed probability of that legislation becoming law.

III. CONCLUSION

For the reasons stated above, it is appropriate to deny the portion of Oak Tree's Motion asking this Commission to reconsider the use of the hybrid calculation method, as it is the appropriate method to establish NWE's avoided cost. Use of an alternative method will not properly reflect the operations of NWE's system and costs associated with those operations. It is appropriate for the Commission to grant the portion of Oak Tree's Motion asking the Commission to reconsider the use of current market conditions and projections to determine proper natural gas and electric market price inputs, as PURPA requires rates to be determined as of the date an LEO is established. It is appropriate to grant the portion of Oak Tree's motion to reconsider the use of Lands Energy's carbon price estimate as this estimate is not properly supported.

Dated this 18th day of June, 2012.

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