

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

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**Docket No. EL11-006**

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

**Commission Staff's  
Post-Hearing Brief**

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On March 21 through 22 , 2012, the South Dakota Public Utilities Commission (Commission) conducted a contested case evidentiary hearing regarding enforcement of a Purchase Power Agreement (PPA) under the Public Utilities Regulatory Policies Act of 1978 (PURPA). Specifically, Oak Tree Energy, LLC. (Oak Tree) brought this matter before the Commission after unsuccessfully seeking to establish a PPA with NorthWestern Corporation d/b/a NorthWestern Energy (NWE) for the purchase of a 19.5 megawatt (MW) wind facility to be constructed in Clark County, South Dakota (Project). Oak Tree and NWE may be jointly referred to as the Parties or individually as Party.

While NWE does not dispute its obligation under PURPA to purchase Oak Tree's output, the Parties do not agree regarding the monetary value of said output. The Parties and Commission Staff (Staff) identified various methods and inputs to calculate the proper monetary value for Oak Tree generation output. Staff appreciates this opportunity to provide the Commission with its final thoughts and post-hearing recommendations.

## **I. NOTICED HEARING ISSUES**

On February 28, 2012, the Commission released its *Order For And Notice Of Hearing*. In an attempt to dissect the larger issues and identify the sub-issues necessary for this Commission to rule on the case, Staff individually addresses each issue identified in the Commission's February 28, 2012 order below.

**1) Whether, and in what amounts, NWE should be required, pursuant to 16 U.S.C. 824a-3 and 18 C.F.R. §§ 292.303 and 292.304, to pay Oak Tree over the life of the Project for electricity made available to NWE from the project? The determination of this issue will require consideration of the avoided cost issues presented by 18 C.F.R. § 292.304, including, but not limited to, both avoided energy costs and avoided capacity costs.**

As previously stated, whether NWE is required to purchase energy and capacity from Oak Tree is not disputed. The Parties agree NWE is under an obligation to do so. The obligation depends on whether Oak Tree holds qualifying facility (QF) status under PURPA and whether Oak Tree has created the obligation to purchase. The status of Oak Tree as a QF is not contested. As evidenced by Exhibit 1 of Oak Tree's *Complaint*, it has filed the necessary FERC Form 556 for certification status as a QF. The Commission can dispose of this issue.

The far more complicated issue on which the Parties disagree is: what avoided cost rate should be applied to the purchase obligation. Again, the Parties agree regarding the implications of Section 210(b) of PURPA, at least in theory. Section 210 requires electric utilities to purchase all electric energy made available by a QF at rates that do not exceed the electric utility's incremental cost of alternative electric energy.

The Parties agree the incremental cost to a utility is the amount it costs the utility to generate or purchase the electric energy if not for the purchase from the QF. The incremental cost standard is intended to leave ratepayers economically indifferent to the source of a utility's energy by ensuring the cost to the utility of purchasing power from a QF does not exceed the cost the utility would incur in the absence of the QF purchase. This cost is otherwise known as a utility's "avoided costs."

Under PURPA, a QF is entitled to a payment reflecting avoided energy costs. This entitlement is due to the fact a utility can avoid costs associated with the production of energy by decreasing the operation of one or more of its own units or by foregoing an energy purchase and replacing that with energy from the QF. In addition, a QF is entitled to an avoided capacity payment from a utility if the purchase of the QF's

capacity permits the utility to avoid building additional capacity of its own or purchasing it from another source. The Parties have both identified, albeit through different methods, what they believe the proper avoided cost to be.

**The issue left for the Commission to determine: In light of the specific facts pertinent to NWE as a South Dakota utility, what is the proper method to determine the avoided cost.**

**2) Whether Oak Tree is currently bound by a legally enforceable obligation, and if so, when that legally enforceable obligation commenced and what impact that has on the avoided cost calculation.**

Once again, it appears the parties agree regarding the applicable law. Pursuant to 18 C.F.R § 292.304(d), a QF shall have the option 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.*

PURPA does not provide a specific procedure on how a QF may establish a LEO. Instead, it directs the states to implement the rules adopted by the FERC to encourage cogeneration and small power production. A state may comply with its obligation to implement PURPA, “1) through the enactment of laws or regulations at the State level; 2) by application on a case-by-case basis by the State regulatory authority; or 3) by any other action reasonably designed to implement FERC's rules.” *Power Resource Group, Inc. v. Public Utility Com'n of Texas*, 422 F.3d 231, 237 (C.A.5 (Tex.),2005)(Citing, *Policy Statement Regarding the Commission's Enforcement Role*

*Under Section 210 of the Public Utility Regulatory Policies Act of 1978, 23 FERC ¶ 61,304, 1983 WL 39627 (May 31, 1983)).*

On February 25, 2011, Oak Tree provided NWE with a letter, along with an executed PPA, stating it was establishing a LEO. (*Complaint*, Ex.10). Oak Tree asserts that this, in conjunction with NWE's unwillingness to negotiate on terms consistent with PURPA, led to the creation of a LEO that binds NWE to purchase energy and capacity from Oak Tree. NWE disagrees an LEO has been created. LEO's are distinct from contractual obligations. It is up to the states, not FERC, to determine the specific parameters of individual QF power purchase agreements, including the date at which an LEO is incurred under state law. *Id.* at 238 (*Citing, W. Penn Power Co., 71 F.E.R.C. ¶ 61,153, 61,495 (May 8, 1995)*).

**The issue left for the Commission to determine: Was a LEO established on February 25, 2011.**

- 3) **Whether additional relief should be granted to Oak Tree as necessary for Oak Tree to obtain a PPA with NWE for electricity produced from the Project on terms that are; (1) consistent with the requirements of PURPA and the SD PUC PURPA Order; and (2) are as consistent as possible with the respective positions of the Parties, the interests of NWE's rate payers, and the public interest.**

Staff does not believe any additional relief is necessary and argues Issue 3 can be eliminated.

## **II. REMAINING CONTESTED ISSUES**

The Commission is left then with two major issues fraught with sub-issues. Staff will address those sub-issues it believes are pertinent to the ultimate goal to determine the proper avoided cost.

**A. IN LIGHT OF THE SPECIFIC FACTS PERTINENT TO NWE AS A SOUTH DAKOTA UTILITY, WHAT IS THE PROPER AVOIDED COST?**

In this case, the Commission was provided with two avoided cost rates, each developed through different modeling methods. FERC does not designate a single methodology for determining avoided cost. (*Public Service Co. of Oklahoma v. State ex rel. Oklahoma Corp. Com'n*, 115 P.3d 861, 876 (Okla.,2005)). Although Staff does not dispute the legitimacy of any the modeling methods themselves, Staff believes specific situations will warrant the use of one modeling method over another. As was illustrated in this case, the various methods can produce very divergent cost estimates for a single utility. This Commission is granted great discretion to determine the proper avoided cost methodology for South Dakota.

As the complainant in this case, to meet its burden of proof, Oak Tree must show it provided the Commission with an avoided cost rate which complies with PURPA. Although Staff acknowledges Oak Tree presented the Commission with a price developed through a recognized and accepted method, Staff does not believe it is the correct method to determine the proper avoided cost for NWE in South Dakota. As a result, Oak Tree met its burden of proof under PURPA to establish an obligation on the part of the utility to purchase. Oak Tree did not, however, meet its burden of proof regarding the established of the proper avoided cost rate.

Staff argues NWE's avoided cost modeling method best suits South Dakota. However, its resulting avoided cost, like Oak Tree's, is fatally flawed. Staff argues neither Party presented an avoided cost rate sufficient to establish proper rates. The flaws of each Party's avoided cost rate become evident through analysis of the specific model chosen and the inputs used in the model itself.

Staff appreciates Oak Tree's urgency to execute a contract with NWE to allow construction and operation of its proposed wind farm to begin. On the other hand, Staff appreciates NWE's fear of rate effects if the incorrect avoided cost is ordered. Finally, Staff anticipates the Commission's desires to bring this contested case to a close on just and reasonable terms. However, Staff does not believe either party offered a

complete avoided cost method and resulting price. As a result, it is not possible for the Commission to order the execution of a PPA with a particular price.

Staff urges the Commission answer the question: what is the proper method to determine the avoided cost. Staff does not believe the Commission can or should decide what the proper avoided cost is. Looking at the evidence provided by the Parties, Staff does not believe the Commission has any choice but to seek new model inputs from the Parties after determining the proper methodology. In support of its recommendation Staff will describe the Party methods, inputs, and corresponding shortcomings and strengths.

## **1. OAK TREE'S CASE**

### **a. Modeling Methodology: The Market Price Modeling Approach**

Staff does not accept Oak Tree's Market Price Modeling Approach. Oak Tree offered two separate methods to calculate avoided cost. The first method is referred to as the Brown Value avoided cost estimate. This calculation method assumes the costs NWE will avoid by taking the output of Oak Tree are spot market purchases as well as some avoided market capacity purchases. The second method is referred to as the Green Value avoided cost estimate. This estimate assumes NWE will avoid building its own wind farm if it purchases the Oak Tree output..

Of these two methods, Staff believes it is necessary to focus only on the Brown Value estimate. As South Dakota's renewable energy objective is not a mandatory compliance standard, the avoided cost estimate should not be based on an assumption NWE will avoid the need to construct its own wind farm as no such need exists. Certainly, South Dakota utilities should not be discouraged from achieving the objective when cost effective, but it does not seem appropriate to attach such an assumption in this proceeding. As such, this review will be limited to Oak Tree's Brown Value estimate.

To develop its Brown Value avoided cost estimate, Oak Tree retained the services of Mr. J. Richard Lauckhart, a consultant employed by Black & Veatch. In very basic terms, Oak Tree's avoided cost estimate uses a long-term market price forecast and applies this forecast to the expected hourly output of the Project. Market energy

prices used by Oak Tree came from the Black & Veatch Fall 2010 Energy Market Forecast for the Midwest United States prepared in November 2010. The expected output of the Project was developed through the collection and analysis of meteorological tower data by AWS Truewind, as well as commercially available wind forecast data. Finally, the calculation involved taking the estimated output of the wind project by hour for each year and multiplying it by the forecast value of market energy on each hour of the year.

To produce a full avoided cost estimate, Oak Tree then produced a capacity value and added this to the estimated avoided energy cost.. For capacity, Oak Tree assumed 20% of the 19.5 MW nameplate capacity of the Project will count towards peak needs and this capacity element will take effect in 2013. Oak Tree calculated a capacity value of \$17 per kilowatt (kW) year, multiplied \$17 per kW by 3,900 kW (3.9 MW) and added this dollar amount each applicable year for avoided capacity costs. (Tr. 92, 16-21)

The result of the Brown Value calculation, accounting for both energy and capacity, produced a 20-year levelized avoided cost of \$78.92 per megawatt-hour (MWh). (*Lauckhart Direct*, Pgs. 4-5). However, Oak Tree offered to sell its output to NWE at a levelized cost of \$65.10 per MWh, which Oak Tree asserts is below the actual avoided cost for NWE. (Tr. 52).

Due to the intermittent nature of wind generation, the output of Oak Tree cannot be dispatched on command. Specifically, it cannot be fully relied upon during periods of peak load when NWE would normally purchase market energy. When NWE's internal generation is sufficient to cover system needs, the only costs NWE can theoretically avoid are the incremental costs of baseload generation. As pointed out by Commissioner Hanson during the March hearing, the incremental costs of NWE's baseload are very low due to the influence "old coal" generating units.

"When demand for electricity is low, a utility can dispatch its lowest operating-cost units and back down, or turn off, its higher cost units. As demand increases, a utility dispatches its more costly units, beginning with the least costly and moving to the most costly. When load is at its highest, a utility must use units with the highest operating costs or purchase market energy. Each increase in the use of a higher cost

unit increases the marginal or incremental cost of producing electricity.” *Public Service Co. of Oklahoma v. State ex rel. Oklahoma Corp. Com'n*, 115 P.3d 861, 880 (Okla.,2005).

At times when NWE is not purchasing market power, the market price estimates used by Oak Tree in its avoided cost calculation will be higher than NWE’s actual avoided cost. Staff finds this result requires NWE and NWE’s customers to pay more for the output of Oak Tree than it would pay if NWE was not taking its output.

Oak Tree asserts that although NWE will not always be purchasing market energy, Staff’s concern is not justified. Specifically, Oak Tree argues that revenues received from the sale of energy and capacity to the market will flow through to ratepayers. If one assumes the overall incremental costs are below the market price, the revenues received will offset any QF payments above the avoided cost. (Tr. 516-517). Staff stands by its concern, however, no provision exists under the current NWE tariff to credit asset-based and non-asset based margins back to customers through the fuel clause. As such, NWE’s customers will not receive the benefit of market energy sales. Provisions to credit customers for such margins have been included in the tariffs of a number of South Dakota utilities in recent rate case proceedings. However, as NWE’s last rate case was filed in the 1980s, there has been no opportunity to update this tariff provision. Unless the Commission develops a mechanism to ensure the ratepayers receive the benefit of revenues, Staff feels an essential assumption of Oak Tree’s model is lost.

Paying Oak Tree a forecasted market price when NWE is long on generation puts NWE ratepayers at the risk of that market price’s accuracy while their current price risk is capped at the baseload price. The market price approach is one of many methods to calculate avoided cost estimates, but it is not the correct model in this case. This model would be more appropriate to calculate the avoided cost for NWE’s Montana system where NWE purchases market power during all hours to satisfy system requirements. (Tr. 79).

The market price modeling approach used by Oak Tree assumes the energy and capacity output produced by the Project will enable NWE to avoid spot market purchases it would otherwise need. Certainly, NWE would avoid some market energy

and capacity purchases at times it would normally purchase market power. However, Staff does not support the use of the market price modeling approach in this case. The market price approach does not properly consider the times when NWE's internal generation is sufficient to cover all system needs. Staff encourages the Commission to adopt a model wherein the avoided cost price can be directly tied to actual avoided utility costs.

STAFF RECOMMENDATION: Staff recommends the Commission reject Oak Tree's modeling method as it does not reflect the reality of NWE's generation portfolio and it does not produce results that accurately reflect costs actually avoided.

#### **b. Input Flaws: Flawed Energy Forecast and Carbon Cost Assumptions**

Staff does not accept Oak Tree's energy forecast or carbon model inputs. The energy values used in Oak Tree's forecast were taken from the Black and Veatch Fall 2010 Energy Market Price Forecast. This energy forecast utilizes fundamentals-based forecasting. Fundamentals-based forecasting, as defined for purposes of this case, makes use of highly complex modeling programs to develop a long-term market price forecast. The program accounts for any number of inputs the user deems likely to impact the price of market power. The vast array of inputs contained in the Black & Veatch forecast is referenced in the 259-page document Mr. Lauckhart attached to his testimony. (*Lauckhart Direct*, Ex. 5).

Developing this type of market energy forecast is highly sophisticated and an enormous undertaking. Yet, this type of long-term price forecasting is highly stochastic. There is always a risk some unforeseen occurrence will render the price estimates unreliable. While Staff does not necessarily agree with all other inputs, two inputs in particular appear unreliable and flawed; natural gas prices and carbon prices.

Staff finds the natural gas prices used in the model to be excessively high. To develop its natural gas price forecast, Black & Veatch used the Gas Price Competition Model (GPCM), a fundamentals-based gas price forecasting model developed by RBAC, Inc. (*Lauckhart Rebuttal*, 12,36-38). The program is simply a model and the

purchaser, Black & Veatch in this case, is responsible for the inputs. The inputs then ultimately create a natural gas price forecast.

After the Black & Veatch natural gas forecast was developed, the EIA announced a large increase in recoverable natural gas which significantly depressed natural gas prices and estimates. Between the times Black & Veatch ran their price forecast model and Oak Tree asked Mr. Lauckhart to determine NWE's avoided cost, the EIA increased their projection of technically recoverable unproved shale gas resources. The projection was nearly 250 percent of the previous estimate, increasing from 347 trillion cubic feet to 827 trillion cubic feet. This drastically affected natural gas price forecasts.

Although Oak Tree admits it did not expect prices to drop as they did, it asserts the drop in prices is no reason to find the forecast unreliable. (Tr. 502). Staff disagrees and finds this price decrease to be a fatal flaw in Oak Trees' inputs. Natural gas prices significantly influence the price of market energy. As a result, Oak Tree's market price forecast is excessive. Staff's concern is compounded by the Market Price model used by Oak Tree. In the Market Price model, all energy units avoided by NWE are valued at forecasted market prices. As a result, Staff finds the avoided energy costs offered by Oak Tree to be far in excess of what Staff believes to be NWE's true avoided cost.

The second major and fatal flaw Staff sees in Oak Tree's inputs is its projected carbon prices. Again, Staff finds the input to be excessively high. Oak Tree's model assumes a CO2 allowance price of (BEGIN CONFIDENTIAL) [REDACTED] (END CONFIDENTIAL). Staff cannot find any justification for such a forecast. This assumption pushes the market price forecast up significantly, beginning in 2016, where Oak Tree predicts the market price to increase by 34.3%. One would assume the economics of such an increase alone would affect the political reality of carbon regulations. As with the natural gas forecast's effect on the avoided cost calculation, Oak Tree's model would compound the effect of this error. Staff continues to believe that the Commission is in the best place to set a CO2 allowance price, should they believe it is reasonable.

STAFF RECOMMENDATION: Staff recommends the Commission reject Oak Tree's natural gas and carbon inputs as they are excessively high, thus creating an excessively high avoided cost.

## **2. NWE'S CASE**

### **a. Modeling Methodology: The Hybrid Method**

Staff agrees generally with NWE's modeling approach as it takes account of the utility's actual generation portfolio and unique South Dakota attributes. To establish its avoided cost calculation, NWE utilized a method it describes as a mixture of the Component/Peaker method and the Market Estimates method (Hybrid Method). The method estimates avoided energy costs for various levels of purchases based on multi-year average historical trends of hourly proportional contributions of baseload generation and wholesale market purchases. The average hourly contribution factors were computed for on-peak and off-peak periods during winter and summer seasons. Finally, the average proportional contribution factors were combined with forecasted incremental baseload production costs and forecasted wholesale market prices to develop the estimated avoided costs in dollars per MWh for 2012 through 2016.

NWE argues its chosen model most accurately reflects the incremental costs of NWE's generation portfolio. Staff agrees. Specifically, NWE's incremental costs include a combination of incremental baseload and spot market purchases. As a result, both generation costs and market costs should be represented in any calculation of avoided energy costs. NWE argues the exclusion of the self-generation cost component from the calculation leads to grossly inaccurate avoided costs. (*Green Direct*, 6, 5-6). Again, Staff agrees.

The Commission, in its F-3365 *Order*, confirmed its view of the continuous changes on a utility's avoided energy costs and explained the hourly incremental costs vary greatly depending on which unit of generation is being added in the next increment. 50 P.U.R. 4<sup>th</sup> 621, 630. In summary, Staff agrees with this modeling approach as it takes account of the utilities actual generation portfolio.

Nevertheless, as in the case of Oak Tree, Staff finds a number of glaring issues in the avoided cost estimate provided by NWE. As a result, Staff cannot recommend the

Commission accept its stated avoided cost. First, the avoided cost does not include the necessary capacity value to develop a full avoided cost estimate. Next, Staff believes the inputs used, or not used, by NWE in developing its avoided cost estimate ignore a number of essential avoided cost elements. Finally, the avoided cost calculation is a five-year energy only avoided cost forecast. (Tr. 434). Such a short-term avoided cost forecast does not assist this Commission set a long-term 20-year avoided cost rate.

STAFF RECOMMENDATION: Staff recommends the Commission order the Parties use the Hybrid Method to determine the proper avoided cost.

**b. Input Flaws**

**i. The Lack of a Capacity Credit Component**

Staff does not accept NWE's failure to incorporate capacity credits into its model. According to the *Order* in F-3365, rates to be paid a QF under the obligation created by section 210 of PURPA shall embody the value of all electric energy, as well as capacity, made available from a QF. *Re Cogeneration and Small Power Production*, 50 P.U.R. 4<sup>th</sup> 621, 633 (SD.P.U.C.1982). Such capacity credits are to be made constant over the duration of the contract in order to enable an established fixed rate to aid a QF in planning its investment. *Id.* at 630.

NWE argues it has no need for capacity through 2015 and cannot be required to pay for capacity if no capacity will be avoided by entering a contract with Oak Tree. This caveat is specifically contained in 18 C.F.R. §292.304(a)(2) and recognized by the Commission in its F-3365 *Order*. 50 P.U.R. 621, 634. However, the lack of a requirement to purchase capacity over the next several years does not alleviate the need to establish a viable 20-year full avoided cost rate. Additionally, NWE's purchase of a capacity contract in 2011 shows a capacity need did exist prior to 2015. Oak Tree's calculation of NWE's avoided cost of capacity may have been underestimated.

(BEGIN CONFIDENTIAL) [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED].(END CONFIDENTIAL). Regardless, an avoided cost rate which does not include this capacity element does not represent NWE's full avoided costs. To set a rate lower than the full avoided cost contradicts the specific language of PURPA and the Commission's F-3365 *Order*. Staff recommends the Commission determine a capacity credit shall be included in the proper avoided cost.

STAFF RECOMMENDATION: Staff recommends the Commission order capacity credits be incorporated into the Hybrid Method starting in 2012.

## **ii. Flawed Energy Price Forecast and Carbon Cost Assumptions**

Staff does not accept NWE's energy forecast or lack of carbon input. In October 2011, Land Energy Consulting (LEC) prepared NWE's energy price forecast for wholesale power prices for South Dakota. To develop its forecast LEC looked to forward market prices from MISO's Minnesota Hub from November 2011 through March 2013 and historical prices from MISO Cinergy Hub in Indiana. Next, to extend the forecast, LEC utilized what is known as a monthly market imputed heat-rate price calculation. The calculation divides electricity prices by the natural gas prices. The method focuses on the historical relationship between these prices to extend its market price forecast from April 2013 through September 2015. LEC applied a fixed yearly escalator of 2.7% for the period of October 2015 through December 2031.

Although the forecast method lacks the complexity of Oak Tree's fundamentals-based approach, Staff does not believe the method is flawed in the short term. Much can be said for using existing market data to develop a future forecast. Staff's primary concern with NWE's resulting market price forecast is the assumption made for the period of October 2015 to December 2031. In applying the fixed escalator rate, NWE's forecast assumes no real increases in natural gas prices. The assumption seems simply unsupported. In fact, Mr. Lewis of LEC admits he is unaware of any organization making this same assumption. Evidence was also provided to suggest nearly all entities

in the business of producing long-term energy price forecasts, including the EIA, assume real increases over the long term. NWE's price forecast would be substantially higher if the EIA's natural gas price forecast was applied to Mr. Lewis' forecast. (Tr. 386).

As a result, Staff finds the proper avoided cost calculation is higher than what is currently offered by NWE. Again, because natural gas prices influence market prices so heavily, Staff believes an arbitrarily low natural gas price forecast will result in an arbitrarily low energy price forecast. An arbitrarily low energy price forecast will then result, as it did here, in a low avoided cost. The underlying theory and viability of NWE's approach is completely dependent on the strong correlation of natural gas prices and market energy prices. This ultimately renders NWE's avoided cost rate unsupportable.

Staff believes Oak Tree overstated its carbon component. We also believe the Commission could find Staff finds NWE's lack of a carbon cost component is flawed. Although, LEC provided NWE an energy price forecast with a carbon cost value included, it was removed prior to submitting its avoided cost estimate. (Tr. 399). Mr. Lewis recognizes a significant number of coal plants retirements and costs associated with regulating greenhouse gas emissions could further impact the electric-gas price relationship. (Tr. 399). He also admits utilities are seriously considering replacing coal generation with natural gas generation and a large shift may take place within the next 10 or 20 years. (Tr. 389).

STAFF RECOMMENDATION: Staff recommends the Commission reject NWE's model inputs as they are excessively low.

### **iii. Flawed Contract Term**

Staff does not accept the contract term put forth by NWE. The contract term will no doubt affect the proper levelized avoided cost rate. Oak Tree asks the Commission to set a contract term of 20 years to the NWE purchase obligation and states nothing in PURPA allows a utility to determine the contract length. (Tr. 14, 8-10). Yet, neither PURPA nor the FERC rules require any particular contract length. *Public Service Co. of Oklahoma*, 115 P.3d 861, 885. As such, the decision on this issue is left to the

discretion of the state regulatory authority to be resolved on a case-by-case basis. *Id.*

In its F-3365 *Order*, the Commission set a distinction between rates for purchases fixed by contract with a duration of less than ten years ('short-term contract') and rates for purchases set by contract with a duration of ten years or more ('long-term contract')...as ten years is the normal planning horizon for utilities under the Commission's jurisdiction. *Re Cogeneration*, 50 P.U.R.4th 621, 630. As such, Staff assumes the contract term must be no less than 10 years.

Also, Staff also finds it difficult to rationalize setting a contract term less than 20 years. It appears NWE normally finances new generation for this length of time or longer. In addition, the resource solicitation LEC conducted on behalf of NWE returned seven wind proposals, which LEC deemed viable, all based on 20-year terms. (Tr. 428). It appears financing new generation resources on a 20-year time period is standard practice in the industry. As a result, Staff supports a 20 year contract term.

As a final note, with a 20 year contract term, Staff recommends that the Commission consider the substantial risk such a long term contract shifts from Oak Tree to NWE's ratepayers. Therefore, when considering the long-term avoided cost, a conservative estimate of avoided costs may be appropriate based on the risks involved with long-term forecasts.

STAFF RECOMMENDATION: Staff recommends the Commission order a 20-year contract term.

## **B. WAS AN LEO ESTABLISHED ON FEBRUARY 25, 2011?**

Staff urges the Commission to adopt a policy to resolve LEO disputes on a case-by-case basis. The existence of an LEO is fact-specific and a precise rule may be inappropriate for such a determination. For instance, the fact a QF sent a letter and an executed PPA may not always be sufficient to establish an LEO, in other cases, it may. It is more appropriate to focus on the actions and behavior of the parties involved to determine whether the situation is of the type for which an LEO was intended.

FERC states use of the term 'legally enforceable obligation' is intended to prevent a utility from circumventing the requirement that provides capacity credit for an

eligible qualifying facility merely by refusing to enter into a contract with the QF. *Power Resource Group, Inc.*, 422 F.3d 231,t 238 (*internal citations omitted*). This requirement is FERC's response to the reluctance of traditional electric utilities to purchase power from nontraditional electric generation facilities, a problem identified by Congress which could hinder the development of such nontraditional facilities. *Id.*

By utilizing a case-by-case approach, the Commission can review particular circumstances in a case and determine if a LEO is warranted. If the Commission believes Oak Tree's offer was in line with the standards of PURPA and NWE refused to enter the agreement, then an LEO was created. Staff believes a determination of this decision depends on the process of negotiations and whether the avoided cost price was within the confines of NWE's incremental cost as defined under PURPA.

In this case, Staff believes a LEO was created on February 25, 2011. This is primarily based on the interactions of the Parties and NWE's unwillingness to negotiate a purchase agreement on terms consistent with PURPA. Oak Tree provided 11 copies of written correspondence between Oak Tree and NWE. Five of NWE's representatives were involved in communications with Oak Tree between December 16, 2010 and March 10, 2011. Although, there is disagreement regarding direct telephonic communication with Mr. Bleau LaFave, this seems of little significance. This is especially true when one considers Mr. LaFave was the NWE contact in eight of the 11 written communications.

The communications clearly show the Parties understood Oak Tree's plans to sell its output to NWE as a QF and its desire to negotiate a purchase price. NWE's responses to Oak Tree, which appear to change little more than the date, simply state it has no need for additional baseload generation. It seems no effort was made to dispute Oak Tree's calculation of NWE's avoided cost, and little effort was made to provide the data Oak Tree would have needed to make the correct calculation.

Beyond communication issues, NWE refused to negotiate above its tariffed rate offered to small power producers of 100kW or less. Under the assumption this rate is correctly calculated, Staff does not dispute that NWE could have been negotiating in good faith. However, it was later determined that the rate was incorrectly calculated, and was thus much lower than NWE now believes their avoided cost to be. In addition,

this rate is not intended for long-term purchase agreements from wind projects such as Oak Tree.

Although Staff does not believe Oak Tree's offer was at or below NWE's true avoided cost, Staff believes Oak Tree made a good faith effort to offer an avoided cost price calculated in a manner consistent with PURPA. As a result, NWE had an obligation to negotiate price and to purchase the output when the proper price was determined. Given their responses and originally incorrect avoided cost calculation, it does not appear NWE attempted to negotiate a viable purchase agreement with Oak Tree. As such, Staff believes a LEO was created based on the behavior of the Parties.

**STAFF RECOMMENDATION:** Staff recommends the Commission find, based on the specific facts of this case, that NWE was legally obligated to purchase Oak Tree output as of February 25, 2011. As such the proper avoided cost price shall be determined from that date.

### **III. CONCLUSION**

To properly resolve this dispute, the Commission needs a sound avoided cost rate. Neither Party provided the Commission with such a rate. Although Staff urges the Commission not to rule on a specific rate, we believe the Commission can establish the following:

- NWE's Hybrid Method is the proper model to calculate the avoided costs of NWE's South Dakota system.
- The Parties have not provided suitable inputs for this model and as a result, the Commission cannot establish the proper avoided cost.
- NWE is obligated to purchase Oak Tree output based on the existence of a LEO created February 25, 2011. As such all model inputs shall be based on said date.
- A capacity credit shall be incorporated into the Hybrid Method beginning in 2012.
- The proper avoided cost contract term is 20 years.

