

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

EL 11-006

NorthWestern Energy's Post-Hearing Brief

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Introduction

This proceeding requires the South Dakota Public Utilities Commission (“Commission”) to more fully examine its implementation of the Public Utility Regulatory Policies Act of 1978 (“PURPA”).

Oak Tree Energy, LLC (“Oak Tree”) has requested that the Commission order NorthWestern Corporation d/b/a NorthWestern Energy (“NorthWestern”) to purchase the energy and capacity from a proposed 19.5-MW wind facility for 20 years at an escalating rate equivalent to a levelized rate of \$65.44/MWh.

NorthWestern has estimated its 20-year incremental cost to be equivalent to a levelized rate of \$35.85/MWh.

Granting Oak Tree’s request would impose over \$52 million of excess costs on NorthWestern’s customers over the 20-year term. Imposing these excess costs would violate PURPA’s customer indifference standard. The Commission should deny Oak Tree’s request.

Argument

PURPA is a child of the 1973–74 Arab oil embargo. In 1977, newly elected President Carter’s first major policy initiative was to promote an energy policy designed to make the country more energy efficient and less dependent on foreign fuel. PURPA sought to eliminate discrimination against qualifying facilities (“QFs”) by utilities while protecting utilities’ customers. PURPA was not intended to provide subsidies to QFs. *See Joint Explanatory Statement of the Committee of Conference*, H.R. Rep. No. 1750, 95th Cong. 2nd Sess. 98 (1978), *reprinted in* 1978 U.S. Code Cong. & Ad. News 7797, 7832 (“not intended

to require the ratepayers of a utility to subsidize cogenerators or small power producers”). This concept is reinforced by the provisions in the Energy Policy Act of 2005 that, with subsequent Federal Energy Regulatory Commission (“FERC”) rules and decisions, eliminated a utility’s mandatory purchase obligation from QFs that had non-discriminatory access to markets. See 16 U.S.C. § 824a-3(m) (2006 & Supp. IV 2011).

Section 210 of PURPA required FERC to adopt rules requiring utilities to purchase electric energy from QFs, 16 U.S.C. § 824a-3(a)(2) (2006 & Supp. IV 2011), established the rates that utilities were required to pay QFs, 16 U.S.C. § 824a-3(b) (2006 & Supp. IV 2011), and required state regulatory agencies to implement the rules that FERC adopted. 16 U.S.C. § 824a-3(f) (2006 & Supp. IV 2011). A state regulatory agency may comply with the statutory requirements by issuing regulations, by resolving disputes on a case-by-case basis, or by taking any other action reasonably designed to give effect to FERC’s rules. *FERC v. Mississippi*, 456 U.S. 742, 751 (1982). See also *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).

Achieving the goals of PURPA depends on a state regulatory commission’s determination of a utility’s incremental costs, authorization of types of rates and lengths of contracts, and limitation of QFs’ ability to impose unreasonable terms on utilities. State regulatory commissions have struggled with implementing PURPA almost from its inception. The problems created by implementation of PURPA were so pervasive that FERC initiated a rule-making docket in which it discussed the problems. See *Administrative Determination of Full Avoided Costs, Sales to Qualifying Facilities, and Interconnection Facilities*,

RM 88-6-000, 53 FED. REG. 9331 (1988) (“RM88-6”). The proposed rules were not adopted because events, particularly the passage of the Energy Policy Act of 1992, overtook the issues. See RM 88-6, 63 FED. REG. 51310 (1998). Nevertheless, RM88-6 provides caution to state regulatory commissions, particularly regarding the potential for administratively determined avoided costs to exceed actual avoided costs over a long period of time.

The Commission should be particularly cognizant of the problems encountered in other states as it goes forward with its implementation of PURPA.

I. The Commission’s determination of NorthWestern’s avoided cost must protect NorthWestern’s customers.

The rates that NorthWestern must pay to Oak Tree are required by statute and administrative rule to be “just and reasonable” in order to protect NorthWestern’s customers, as well as to be non-discriminatory to QFs. 16 U.S.C. § 824a-3(b) (2006 & Supp. IV 2011) provides:

(b) Rates for purchases by electric utilities

The rules prescribed under subsection (a) of this section shall insure that, in requiring any electric utility to offer to purchase electric energy from any qualifying cogeneration facility or qualifying small power production facility, the rates for such purchase –

- (1) shall be just and reasonable to the electric consumers of the electric utility and in the public interest, and
- (2) shall not discriminate against qualifying cogenerators or qualifying small power producers.

No such rule prescribed under subsection (a) of this section shall provide for a rate which exceeds the incremental cost to the electric utility of alternative electric energy.

Similarly, 18 C.F.R. § 292.304 (2011) provides, in part:

- (a) Rates for purchases.
 - (1) Rates for purchases shall:
 - (i) Be just and reasonable to the electric consumer of the electric utility and in the public interest; and
 - (ii) Not discriminate against qualifying cogeneration and small power production facilities.
 - (2) Nothing in this subpart requires any electric utility to pay more than the avoided costs for purchases.
- (b) Relationship to avoided costs.
 - (1) For purposes of this paragraph, “new capacity” means any purchase from capacity of a qualifying facility, construction of which was commenced on or after November 9, 1978.
 - (2) Subject to paragraph (b)(3) of this section, a rate for purchases satisfies the requirements of paragraph (a) of this section if the rate equals the avoided costs determined after consideration of the factors set forth in paragraph (e) of this section.

The purpose of the limitations regarding incremental cost and avoided cost in the statute and regulation is to protect a utility’s customers.

The Commission has broad discretion in determining NorthWestern’s incremental cost and the specific avoided cost associated with Oak Tree. Determination of avoided cost is fact specific. *See, e.g., Re Cal. Pub. Util. Comm’n*, 134 FERC ¶ 61,044, ¶ 61,162 (2011).

However, the Commission may not impose a rate greater than NorthWestern’s actual avoided cost. *State ex rel. Util. Comm’n v. N.C. Power*, 450 S.E.2d 896, 900 (N.C. 1994) (citing *Re Orange & Rockland Util., Inc.*, 43 FERC ¶ 61,067, ¶ 61,194 (1988)) (“It is beyond dispute that the states cannot impose rates exceeding avoided cost in implementing the

[FERC's] rules under section 210(a) of PURPA.”)). The Commission may not determine NorthWestern's avoided cost without considering the characteristics of NorthWestern's resource mix and load requirements.

A. NorthWestern's methodology correctly considers its resources and loads.

NorthWestern has substantial and varied resources to serve its load. NorthWestern owns approximately 204 MW of baseload coal generation¹, 25 MW of wind (Titan Wind), 75 MW of larger peaking facilities², and approximately 30 MW of small internal combustion generators that are used for reliability.

NorthWestern serves an average load of approximately 180 MW and a peak load of approximately 340 MW. NorthWestern has more than enough baseload generation to serve its average load. NorthWestern uses its larger peaking facilities or market purchases, whichever is more economical, to serve load in excess of its baseload generating capacity plus its contracted wind generation from Titan Wind. Most hours of the year, NorthWestern does not need to either operate its peaking plants or make market purchases. In fact, NorthWestern serves approximately 93% of its load with its own generation and wind and serves only approximately 7% of its load with market purchases. (*Prefiled Direct & Rebuttal Testimony of Richard J. Green (“Green Test.”) 3:24–30.*)

In calculating its incremental costs, NorthWestern recognized that in any hour for a given QF size, it could be serving its load in one of three ways. (Green Test. 7:15–33.) First, it could be serving its load with baseload generation only. NorthWestern calculated this incremental cost equal to the variable cost of Big Stone, its highest cost baseload plant.

¹ Big Stone – 106 MW, Neal #4 – 55 MW, and Coyote #1 – 43 MW.

² Aberdeen – 20.5 MW, Huron #1 – 11 MW, and Huron #2 – 43.7 MW.

Second, NorthWestern could be serving its load with baseload generation plus market purchases in excess of the size of the QF. It calculated this incremental cost equal to the market price. Finally, NorthWestern could be serving its load with baseload generation plus market purchases less than the size of the QF. NorthWestern calculated this incremental cost equal to the weighted average of the market price for the volume of market purchases and the variable cost of Big Stone for volume of the QF contribution in excess of the market purchases.

1. NorthWestern's incremental cost.

As is evident from the description of load and resources, during most hours of the year, NorthWestern does not need any additional energy. However, a QF may always sell energy to a utility on the theory that the utility can reduce its own generation. *Pub. Serv. Co. of Okla. v. State ex rel. Okla. Corp. Comm'n*, 115 P.3d 861, 876 (Okla. 2005). For these periods, the proper measure of incremental cost is the variable cost of the owned generation. See 16 U.S.C. § 824a-3(d) (2006 & Supp. IV 2011) (definition of incremental cost of alternative energy).

Bleau LaFave presented NorthWestern's calculation of incremental cost based on the variable cost of Big Stone, the estimated future market prices determined by Lands Energy, and the estimated increasing share of market purchases in NorthWestern's portfolio of resources. NorthWestern calculates its off-peak incremental cost in 2013 to be \$23.35/MWh, increasing to \$38.63/MWh in 2032. NorthWestern calculates its on-peak incremental cost to be \$28.85 in 2012, increasing to \$63.28/MWH in 2032. (*Filed Direct & Rebuttal Testimony of Bleau J. LaFave, Ex. BJL-1.*)

2. *Other factors reduce, not increase, the avoided cost applicable to Oak Tree.*

18 C.F.R. § 292.304(e) (2011) requires the following factors to be considered when determining an avoided cost rate for a particular QF:

- (1) The data provided pursuant to § 292.302(b), (c), or (d), including State review of any such data;
- (2) The availability of capacity or energy from a qualifying facility during the system daily and seasonal peak periods, including:
 - (i) The ability of the utility to dispatch the qualifying facility;
 - (ii) The expected or demonstrated reliability of the qualifying facility;
 - (iii) The terms of any contract or other legally enforceable obligation, including the duration of the obligation, termination notice requirement and sanctions for non-compliance;
 - (iv) The extent to which scheduled outages of the qualifying facility can be usefully coordinated with scheduled outages of the utility's facilities;
 - (v) The usefulness of energy and capacity supplied from a qualifying facility during system emergencies, including its ability to separate its load from its generation;
 - (vi) The individual and aggregate value of energy and capacity from qualifying facilities on the electric utility's system; and
 - (vii) The smaller capacity increments and the shorter lead times available with additions of capacity from qualifying facilities; and
- (3) The relationship of the availability of energy or capacity from the qualifying facility as derived in paragraph (e)(2) of this section, to the ability of the electric utility to

avoid costs, including the deferral of capacity additions and the reduction of fossil fuel use; and

- (4) The costs or savings resulting from variations in line losses from those that would have existed in the absence of purchases from a qualifying facility, if the purchasing electric utility generated an equivalent amount of energy itself or purchased an equivalent amount of electric energy or capacity.

The data provided pursuant to § 292.302(b) has been considered and is the underlying basis of NorthWestern's calculations.

The ability to dispatch a QF “refers to a utility’s ability to control a resource’s output, including the ability to turn the plant ‘on’ and ‘off’ at the dispatcher’s discretion based on consumer power demands and the seasonal availability of more cost-effective power” *Rosebud Enter., Inc. v. Idaho Pub. Util. Comm’n*, 917 P.2d 766, 771 n.2 (Idaho 1996). Because Oak Tree would be an intermittent resource, NorthWestern would have no ability to control its output or to dispatch it, unlike NorthWestern’s control of its own resources and market purchases. The avoided cost should be discounted from NorthWestern’s incremental cost for this factor.

Similarly, the other factors related to Oak Tree as a resource are less favorable than NorthWestern’s owned generation or short-term market purchases.

During the hearing on this matter, advisory staff for the Commission questioned whether NorthWestern’s variable cost of operating its coal plants would increase due to environmental upgrades. (See Hr’g Tr. vol. I, 276:24–278:8, Mar. 21, 2012.) The Commission should recognize the difference in costs attributable to environmental upgrades. Capital costs, such as equipment, may increase the overall cost of the resources but will not increase the variable operating costs. These costs are not costs that

NorthWestern can avoid by purchasing from Oak Tree. As Mr. LaFave testified, there may also be some variable costs associated with changed operations. (*Id.*) However, NorthWestern, Oak Tree, and the Commission's advocacy staff did not offer any testimony as to the magnitude of such variable costs. Without record evidence, any adjustment for these costs would be speculative and could cause the rates to exceed NorthWestern's actual incremental costs in violation of PURPA.

Also during the hearing, Commissioner Nelson asked for a copy of the Titan Wind Purchase Power Agreement. (Hr'g Tr. 262:4-9.) Titan Wind does not represent NorthWestern's avoidable cost. NorthWestern is obligated to take or pay for all of the output of Titan Wind. NorthWestern cannot reduce its payments to Titan Wind. Therefore, consideration of the cost of Titan Wind in determining NorthWestern's incremental cost would be inappropriate and contrary to the statutory definition.

3. The Commission should limit any payments for capacity.

Oak Tree claims that it is offering to sell capacity as well as energy and that NorthWestern needs capacity. There is confusion about the issues surrounding (1) Oak Tree's capacity, (2) any Oak Tree offer to sell capacity, (3) NorthWestern's need for capacity, and (4) NorthWestern's obligation to purchase capacity.

First, although Oak Tree is projected to be a 19.5-MW wind generating facility, it does not provide 19 MW of capacity. Wind is an uncontrollable, non-dispatchable, intermittent resource, and the capacity provided by wind generation is only a fraction of its nameplate capacity. Regional reliability organizations determine the percentage of wind nameplate capacity that may be counted as capacity. Oak Tree has assumed that it will

provide 20% of its nameplate capacity, or 3.9 MW of capacity. (*Direct Testimony of J. Richard Lauckhart* (“Lauckhart Direct Test.”), Ex. 3; Hr’g Tr. 92:6–21.) However, NorthWestern’s current method of determining capacity from wind projects, which it adopted from the Midwest Independent System Operator’s (“MISO”) method, does not allow 20% of nameplate capacity to be counted. The amount of capacity that any given wind farm contributes is determined annually by comparing the wind farm’s actual output to nameplate capacity during critical hours. This calculation is updated annually. Although each wind farm is different, during the past three years the average countable capacity has ranged from 8% to 12.9%. (*Responsive Testimony of Dennis L. Wagner* 1:25–27.) While it is not known exactly how much capacity Oak Tree would provide, it is more likely to be 35 to 65% less than Oak Tree assumed, or in the 1.5 MW to 2.5 MW range.

Second, although Oak Tree claims that it has offered to sell capacity, Oak Tree never made any offer to NorthWestern to sell its capacity without its energy. (Hr’g Tr. 278:21–279:3.) Any sale of capacity that includes energy at the rates demanded by Oak Tree necessarily exceeds NorthWestern’s incremental costs.

Third, although NorthWestern’s need for capacity has changed throughout the time since Oak Tree’s first contact, NorthWestern has never misrepresented its capacity needs to Oak Tree. When Oak Tree first contacted NorthWestern in 2010, NorthWestern correctly represented that *at that time* it did not need capacity until 2012. Later, after NorthWestern entered into capacity contracts and finalized its plans for the new Aberdeen peaking plant, NorthWestern correctly represented that it did not need capacity until

2016. NorthWestern's decisions to acquire capacity were reasonable and prudent given the facts that NorthWestern knew when making those decisions.

Fourth, PURPA provides guidance as to when a utility is required to purchase capacity from a QF and the amount that it is required to pay. A utility is not required to pay for capacity from a QF that it does not need. *Pub. Serv. Co. of Okla.*, 115 P.3d at 875 n.53. During the hearing, some questions seemed to suggest that NorthWestern was arguing that if it had been paying Oak Tree for capacity and then acquired additional capacity such that the QF capacity was not needed, it could stop paying the QF. This suggestion misrepresents NorthWestern's argument. NorthWestern asserts that it is not required to pay Oak Tree for capacity until NorthWestern actually needs capacity—2016. However, once NorthWestern begins paying for capacity, it will continue to pay for that capacity regardless of subsequent acquisitions.

Plans for subsequent acquisitions do affect the long-term price for capacity. The price a utility is required to pay for capacity is determined by the resource, owned or purchased, that the purchase from the QF will allow the utility to avoid. A commission may not continue to escalate the price of capacity past the time that the utility plans to acquire a resource. See *Armco Advanced Materials Corp. v. Pa. Pub. Util. Comm'n*, 664 A.2d 630, 637–39 (Pa. Commw. Ct. 1995) (discussing that capacity costs are fixed when a resource is acquired and that to escalate capacity costs past the expected date would require a utility to pay more than avoided cost). Oak Tree proposes to escalate the cost of capacity throughout its requested 20-year term. NorthWestern's 2009 Integrated Resource Plan shows that it intends to acquire another peaking facility within a few years.

The Commission should not require NorthWestern to pay for any capacity from Oak Tree before it is needed—2016, should limit payments for capacity to the actual amount of capacity that Oak Tree provides, and should stop any escalation of capacity costs at the time that NorthWestern acquires an additional peaking unit.

B. Oak Tree's estimate of NorthWestern's avoided cost is contrary to statutory requirements.

Oak Tree's expert witness, J. Richard Lauckhart, estimated NorthWestern's 20-year levelized avoided cost to be either \$78.92/MWh or \$70.81/MWh. (Lauckhart Direct Test. 5.) To calculate the \$78.92, Mr. Lauckhart multiplied the assumed output of Oak Tree by the Black & Veatch forecast of spot market energy and added an annual capacity value and divided the total by the assumed output of Oak Tree. (Lauckhart Direct Test., Ex. 3; Hr'g Tr. 64:13-22.)

This is an illegal method for determining NorthWestern's avoided cost in South Dakota because it fails to consider and account for the fact that in most hours of a year NorthWestern will not avoid market purchases and could only reduce its own generation. Any method of calculating avoided cost must consider all resources available to the utility. *See, e.g., Metro. Edison Co.*, 72 FERC ¶ 61,015, ¶ 61,049 (1995) (citing *S. Cal. Edison Co.*, 70 FERC ¶ 61,215, ¶ 61,677 (1995)). Oak Tree may not ignore NorthWestern's incremental cost determined by the variable cost of its own generation for the hours in which NorthWestern is not making market purchases.

Oak Tree's second method of estimating NorthWestern's avoided cost is also illegal. To calculate the \$70.81/MWh, Mr. Lauckhart calculated the revenue requirement

for a NorthWestern-owned wind generation facility of the same size as Oak Tree.

(Lauckhart Direct Test. 5.)

The Commission may set avoided costs based on a specific type of resource only if South Dakota imposes an obligation to purchase from that type of resource. *See Cal. Pub. Util. Comm'n*, 133 FERC ¶ 61,059, ¶ 61,266 (2010). South Dakota does not impose an obligation on NorthWestern to purchase from wind or other renewable generation resources. (*Prefiled Direct & Rebuttal Testimony of Pamela A. Bonrud* 2:9-11.)

1. Oak Tree's method impermissibly transfers developer's risk to NorthWestern's ratepayers.

Oak Tree has requested a 20-year, escalating price contract. (Lauckhart Direct Test. 3.) If the Commission so orders, and NorthWestern enters into such a contract, then the terms are fixed for the entire period. Neither the Commission nor NorthWestern can modify the terms of such a contract. *See, e.g., Freehold Cogeneration Assoc., L.P. v. Bd. of Regulatory Comm'rs of N.J.*, 44 F.3d 1178, 1194 (3d Cir. 1995) (“Finally, we hold that once the BRC approved the power purchase agreement between Freehold and JCP & L on the ground that rates were consistent with avoided cost, any action or order by the BRC to reconsider its approval or to deny the passage of those rates to JCP & L's consumers under purported state authority was preempted by federal law.”).

Therefore, once a contract is entered into, NorthWestern's ratepayers will be liable for the costs. Oak Tree is asking the Commission to set contract rates based on its estimate of spot market prices. NorthWestern's customers will bear the risks that the actual market price is lower than Oak Tree's estimate, that NorthWestern will not need Oak Tree's

output to serve load in any given hour, and that Oak Tree will not supply the capacity that is included in Oak Tree's derivation of its contract rates.

Economic indifference includes both price and risk. If the Commission were to impose these risks on NorthWestern's customers, it would be violating the important principle of customer indifference. This is true especially because long-term price forecasts are inherently unreliable.

2. Oak Tree's estimate of NorthWestern's avoided cost is not reliable.

Even if the Oak Tree method were legal, its estimate of NorthWestern's avoided costs is not reliable. Oak Tree uses an "off the shelf" estimate of spot market prices prepared by Black & Veatch. The estimate was sponsored by J. Richard Lauckhart. (Lauckhart Direct Test., Ex. 5.) However, Mr. Lauckhart did not gather the data that was used in preparing the estimate, did not make the assumptions that were used, and does not work for Black & Veatch currently. (Hr'g Tr. 67:12, 67:18 & 62:9.) There is inadequate foundation upon which to conclude that the Black & Veatch estimate accurately reflects the market.

There are many infirmities in the Black & Veatch estimate that can be discussed without discussing the protected material. Black & Veatch's estimate for 2011 is substantially higher than the prices that actually occurred. (*Prefiled Direct & Rebuttal Testimony of Steven E. Lewis* ("Lewis Direct Test.") 5:3-4, 5:8-13.) Black & Veatch's estimate exceeds the then-current forward market prices through 2015. (*Id.* 5:15-19.) Black & Veatch forecasts increasing natural gas prices without considering the fundamental change that the natural gas industry underwent prior to the preparation of its estimate. (Hr'g Tr.

93:7-96:19.) Black & Veatch's estimate incorporates significant carbon penalties that are not reasonable. (Lewis Direct Test. 5:25-6:19.)

C. The Commission has discretion to determine the types of rates and the lengths of contracts that it will authorize.

Oak Tree asserts that it is entitled to a fixed or escalating rate and that it may impose a 20-year term contract on NorthWestern. For the first proposition, Oak Tree cites to the Preamble to FERC's Order 69 in which it first adopted its PURPA regulations. (Hr'g Tr. 17:25-18:23.) For the second proposition, Oak Tree cites 18 C.F.R. § 292.304(d)(2) (2011).

Neither of Oak Tree's assertions withstands scrutiny. With respect to fixed rates, the preamble to the current rules is not law. The regulations require fixed rates for QFs smaller than 100 kW only. 18 C.F.R. § 292.304(c)(1) (2011). FERC has recognized that it made statements in the preamble to the rules that cannot be sustained. *See, e.g., Orange & Rockland Util., Inc.*, 43 FERC ¶ 61,067, ¶ 61,195 (1988). Also, FERC has clarified that rates may be formula rates, not fixed rates. *See* RM88-6 (1988). The Commission may authorize or require rates for a QF as large as Oak Tree to be calculated periodically based on a formula or based on a market index. Neither Oak Tree nor NorthWestern may dictate to the other what type of rate will be used. Choice of the type of rate is within the Commission's discretion. However, Oak Tree and NorthWestern could agree to a fixed rate without the Commission's authorization. 18 C.F.R. § 292.301(b) (2011).

With respect to the length of the contract, Oak Tree is inserting language into the regulation that is not there. 18 C.F.R. § 292.304(d)(2) (2011) provides:

Each qualifying facility shall have the option either: . . .
 (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 purchase shall, at the option of the qualifying facility exercised prior to the beginning of the specified term, be based on

This section grants the QF the right to determine when the rate shall be calculated.

Nothing in the section gives the QF the right to determine the length of the specified term.

The Commission, not Oak Tree or NorthWestern, has the authority to dictate the length of the specified term. *See, e.g., N.Y. State Elec. & Gas Corp. v. Saranac Power Partners, L.P.*, 117 F. Supp. 2d 211, 217 (N.D.N.Y. 2000), *aff'd*, 267 F.2d 128 (2d Cir. 2001) (New York PSC required 15-year contracts).

Contrary to Oak Tree's assertions, the Commission, not Oak Tree, may dictate the type of rate and the length of any contract. The Commission should adopt rate types and contract lengths that do not impose additional risks on NorthWestern's customers.

II. Oak Tree did not create a legally enforceable obligation ("LEO").

The Commission identified the following as an issue in this proceeding:

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.

The Commission should conclude that Oak Tree has not incurred an LEO.

A. The Commission may determine what is necessary to create an LEO in South Dakota.

18 C.F.R. § 292.304(d) (2011) provides:

Each qualifying facility 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.

However, FERC has not defined what constitutes an LEO. Rather, FERC has ruled, "It is up to the States, not [FERC], to determine the specific parameters of individual QF power purchase agreements, including the date at which a legally enforceable obligation is incurred under State law." *Metro. Edison*, 72 FERC at ¶ 61,050; *New PURPA 210(m) Regulations Applicable to Small Power Production and Cogeneration Facilities*, 119 FERC ¶ 61,305, para. 139 (2007) ("[I]t is the state regulatory authorities (or non-regulated utilities) that determine whether and when a legally enforceable obligation is created, and the procedures for obtaining approval of such an obligation."). Determining the date at which an LEO is incurred requires determining what establishes an LEO under state law. This is a matter of first impression for the Commission.

In a previous motion, Oak Tree asserted that FERC's recent decisions in *Cedar Creek Wind, LLC*, 137 FERC ¶ 61,006 (2011) ("*Cedar Creek*"), and *JD Wind 1, LLC*, 129 FERC ¶ 61,148 (2009) ("*JD Wind*"), established new standards and limit the Commission's

discretion. While both cases provide guidance, neither case significantly limits this Commission's discretion with respect to determining what establishes an LEO under South Dakota law.

1. The Cedar Creek decision.

The *Cedar Creek* decision involved an Idaho Public Utilities Commission ("PUC") decision determining that a QF had not created an LEO because the utility had not signed a power purchase agreement. Prior to December 14, 2010, wind QFs in Idaho up to 10 MW were allowed to sell power at a published standard offer rate. After December 14, 2010, the standard offer rate was limited to wind QFs not larger than 100 kW. The QF and the utility had agreed to all contract terms, and the QF submitted a signed contract to the utility prior to December 14, 2010. The utility did not sign the contract before December 14, 2010. The power purchase agreements were submitted to the Idaho PUC for approval. The Idaho PUC rejected the contracts and adopted a bright-line rule that an LEO could be created only if a power purchase agreement had been signed by both parties.

FERC ruled that the Idaho PUC's bright-line rule violated the federal PURPA regulations. "We accordingly find that the Idaho PUC's requirement that an executed contract was necessary to create a legally enforceable obligation in these circumstances is inconsistent with PURPA and the Commission's regulations implementing PURPA." *Cedar Creek*, 137 FERC ¶ 61,006, para. 37. However, FERC did not determine that the QF had created an LEO. "Whether the conduct of Cedar Creek and Rocky Mountain Power constituted a legally enforceable obligation subject to the Commission's PURPA regulations is not before us." *Id.* para. 38.

2. *The JD Wind Decision.*

The *JD Wind* decision can only be understood within the context of the Texas administrative rule regarding establishment of an LEO and a court case upholding the validity of the administrative rule. A Texas PUC rule provides that a QF may create an LEO only if it is able to deliver electricity within 90 days. Tex. Admin. Code tit. 16, § 25.242(f)(1)(B). A QF challenged the validity of this rule after it had submitted a written commitment to sell its output and a utility denied the existence of an LEO. *Power Res. Group, Inc. v. Pub. Util. Comm'n of Tex.*, 422 F.3d 231, 232–34 (5th Cir. 2005). The court stated, “The primary issue before this Court is whether the PUC’s rule that a legally enforceable obligation arises only when a qualified facility can deliver power within 90 days runs afoul of PURPA and its associated federal regulations.” 422 F.3d at 237. In its analysis, the Court stated that the QF “has failed to show that PURPA and the FERC regulations mandate that all QFs, including unbuilt ones, must be able to create a LEO at any time.” 422 F.3d at 238. The Court found that the administrative regulation limiting the establishment of an LEO to QFs that were built was valid. 422 F.3d at 239. Absent a contrary ruling from a higher court, the Fifth Circuit’s decision is binding precedent in its circuit and persuasive precedent elsewhere.

In 2007, *JD Wind* and some of its affiliates filed a complaint with the Texas PUC seeking an LEO. 129 FERC at ¶ 61,269. The Texas PUC affirmed an administrative law judge’s decision that *JD Wind* could not create an LEO because it could not deliver firm power. 129 FERC at ¶ 61,630. FERC declined to institute an enforcement action against the Texas PUC, but found that restricting the ability to create an LEO to QFs selling firm

power was inconsistent with PURPA and FERC's regulations. 129 FERC at ¶ 61,632-33. FERC did not, and could not, overrule the Fifth Circuit's decision in *Power Resource Group*.

B. The decisions in other states demonstrate the range of possibilities.

Other states have taken a broad range of positions on what establishes an LEO. The Texas position is discussed above relative to *JD Wind*. A review of representative state positions follows, in alphabetical order.

Idaho

The Idaho Supreme Court ruled that the PUC had authority to establish a requirement that before a QF can lock in a cogeneration rate there must be a signed contract to sell at that rate or it must file a meritorious complaint alleging the project as mature and the QF had attempted (but failed) to negotiate a contract with the utility. *A.W. Brown Co. v. Idaho Power Co.*, 828 P.2d 841 (Idaho 1992). Furthermore, a QF does not establish an LEO by seeking information in order to assess the viability of a project. *In re Enforceability of IPUC Order Nos. 25454, 25706 and 25787*, 951 P.2d 521, 526 (Idaho 1997). In this proceeding, a utility offered to purchase the output of a QF at specified rates; the QF responded that "although the . . . rates were substantially less than [it] believed were appropriate, [it] was willing to take a contract with complete terms to its fuel suppliers, financiers, and vendors to determine whether the contract would support a project." 951 P.2d at 524. The PUC and the court held that the QF did not incur an LEO. 951 P.2d at 525. Similarly, a non-binding contract right to sell power at a fixed avoided cost is not an LEO. *Rosebud Enter., Inc. v. Idaho Pub. Util. Comm'n*, 917 P.2d 766, 777 (Idaho 1996).

Minnesota

In a case of first impression for the Minnesota PUC, a QF filed a complaint alleging that a utility had failed to negotiate in good faith or to sign a power purchase agreement and argued that the QF had an LEO. *In re Complaint of LS Power Corp. against N. State Power Co.*, Docket No. E-002/C-92-899, 1993 WL 732529, at *2 (Minn. P.U.C. Apr 12, 1993). LS Power had submitted to the utility a term sheet in March 1992 and a contract on August 6, 1992, one day before it filed its complaint. *Id.* at *3. The PUC stated:

Commissions and courts in other jurisdictions have generally found a LEO to exist when a QF has done everything within its power to create an enforceable obligation such that only an act of acceptance by the utility or approval by the state regulatory authority remains to establish the existence of a contract. This inquiry is very fact-specific and involves the consideration of a number of factors, including but not limited to (1) price; (2) site and design details of the proposed QF; (3) interconnection plans; (4) financing for the project; and (5) fuel supply.

Id. The PUC found that LS Power did not have an LEO either on the day that it submitted a term sheet or on the day that it submitted a signed contract. *Id.* at *4. The PUC discussed the lack of detail about the issues it identified in both the term sheet and the contract and stated, “It is clear from the record that further negotiations are required to achieve the completeness and specificity necessary to support a finding that LS Power . . . has a LEO.” *Id.* at *3-4.

Montana

The Montana Public Service Commission (“PSC”) has adopted a bright-line test: “To establish an LEO, a QF must tender an executed power purchase agreement to the utility *with a price term consistent with the utility’s avoided costs*, with specified beginning and

ending dates, and with sufficient guarantees to ensure performance during the term of the contract, and an executed interconnection agreement. The executed contract demonstrates an unconditional commitment.” *In re Petition of Whitehall Wind, LLC, for QF Rate Determination*, Docket No. 2002.9.100, Order No. 6444e, ¶ 47 (Mont. P.S.C. June 4, 2010) (emphasis added).

New Hampshire

In New Hampshire, a QF creates an LEO when it files a timely and eligible rate petition accompanied by a signed interconnection agreement. *Appeal of Pub. Serv. Co. of N.H.*, 539 A.2d 275, 280 (N.H. 1988). The New Hampshire PUC has established a two-part framework for determining if a QF qualifies for a front-end loaded, long-term rate order: (1) the rate petition must be timely; and (2) the QF must demonstrate its eligibility. 539 A.2d at 281.

To meet the timeliness factor, the QF must demonstrate that most of the developmental problems have been resolved, creating a reasonable expectation that the project will be on-line on the date specified in the rate filing. For example, the New Hampshire PUC found that a small power producer met the timeliness component when it had received site development approval from the city, had obtained an air quality permit from the state, had secured property rights to the project site, had negotiated a steam sales contract, and had demonstrated that the project design and construction planning had advanced to a stage where “not-to-exceed” construction quotations had been provided by reliable design and construction firms, and where financing arrangements had advanced to

a stage where a rate order was warranted. *Id.* To meet the eligibility factor, the QF must demonstrate that the project be viable over the term of the rate obligation.

Oklahoma

In Oklahoma, only a QF that demonstrates it is a viable project can incur an LEO. *Smith Cogeneration Mgmt., Inc. v. Corp. Comm'n*, 863 P.2d 1227, 1234 (Okla. 1993). “[I]n order for a qualifying facility to be entitled to have avoided costs set for the life of a project, based on the date of the QF’s action, the cogenerator must do something more than enter into negotiations.” 863 P.2d at 1233–34. A QF that did not present a contract to the utility that obligated it to deliver power; had not obtained a contract for construction, operation, and maintenance of the project; and had not obtained a contract for purchase of natural gas was found not to have demonstrated its viability and not to have an LEO. 863 P.2d at 1234–35.

In a subsequent case, a QF was able to show that it was a viable project. *Pub. Serv. Co. of Okla. v. State*, 115 P.3d 861 (Okla. 2005). The record contained substantial evidence that significant progress had been made toward bringing the QF into existence. Its principals had invested significant amounts of time, effort, and money into the project. Although not all contracts had been finalized, meaningful progress had been made toward the project’s completion, “including but not limited to, attempts in obtaining environmental and other necessary permits, in securing contracts for natural gas supply and transportation, for construction of the facility, and for the operations and maintenance contract, including site studies, plant design, and negotiations with vendors for these services. [QF] has also taken steps to secure financing. [QF] has continued to

develop the [facility] and has now executed definitive contracts for construction, operations and maintenance and for its natural gas supply and transportation.” 115 P.3d at 873 n.37.

Oregon

The development of LEO law in Oregon illustrates the difficulties associated with state regulatory agency implementation of PURPA. LEO case law demonstrates a progression that started with few requirements to establish an LEO and ended with stringent requirements. The first case to determine the parameters of creating an LEO was *Snow Mountain Pine Co. v. Maudlin*, 734 P.2d 1366 (Or. Ct. App. 1987). In *Snow Mountain*, the court found that a QF incurred an LEO when it tendered a contract to a utility without regard to the price, partially because the price could be negotiated or set by the administrative body. 734 P.2d at 1371.

Subsequently, the Oregon PUC repealed certain provisions of its administrative rules. “In describing the consequences of repealing those rules, the Commission stated: ‘Rates for purchases greater than avoided cost would not be allowed.’” *Portland Gen. Elec. Co. v. Or. Energy Co., LLC*, Order No. 98-055, 1998 WL 460317, *3 (Or. P.U.C. Feb. 17, 1998) (quoting AR 174, Order No. 87-1115)). Interpreting the new rules, the Commission concluded that a QF that tendered a contract with a price that exceeded the utility’s avoided cost by \$3.60/MWh had not created an LEO stating:

We conclude that PGE’s motion for summary disposition should be granted. The September 11, 1996, proposal by [QF] contained specific price terms for purchase of power that exceed PGE’s avoided cost. There is no obligation under PURPA or the regulations or state laws and rules promulgated pursuant to PURPA for a utility to purchase power at more than its avoided cost. . . . Therefore, the

September 11 proposal did not create a legally enforceable obligation.

Id. at *8.

After the *Portland General* decision, the Oregon PUC adopted an administrative rule that defines when the time an obligation to purchase the energy or capacity is incurred as the earlier of “(a) the date on which a binding written obligation is entered into between a qualifying facility and a public utility to deliver energy, capacity, or energy and capacity; or (b) the date agreed to, in writing, by the qualifying facility and the electric utility as the date the obligation is incurred for the purposes of calculating the applicable rate.” Or. Admin. R. 860-029-0010(29). In a challenge to a utility’s interpretation of the rule based on *Snow Mountain Pine Co.* and a contention that QFs would be left without recourse, the PUC upheld its validity. *Int’l Paper Co. v. PacifiCorp*, UM 1449, Order No. 09-439, 2009 WL 3771211 (Or. P.U.C. Nov. 4, 2009).

Pennsylvania

After a long series of cases, Pennsylvania courts and the Pennsylvania PUC have determined that to create an LEO a viable QF must have done everything in its power to create an LEO, must have obligated itself to deliver power, and must not be able to abandon the project without liability to the utility. See *S. River Power Partners, LP v. Pa. Pub. Util. Comm’n*, 696 A.2d 926 (Pa. Commw. Ct. 1997); *Pa. Elec. Co. v. Pa. Pub. Util. Comm’n*, 677 A. 2d 831 (Pa. 1996); *Pa. Elec. Co. v. Pa. Pub. Util. Comm’n*, 648 A.2d 63 (Pa. Commw. Ct. 1994); *Armco Advanced Materials Corp. v. Pa. Pub. Util. Comm’n*, 579 A.2d 1337 (Pa. Commw. Ct. 1990).

The Commonwealth Court of Pennsylvania has noted that the legally enforceable obligation is the obligation of the QF to deliver energy and capacity. *Armco*, 579 A.2d at 1345. While the rule allows a QF to lock in avoided cost projections even without a contract, it does not pertain to a QF that has not incurred an obligation to deliver. *Id.* A QF must be willing and able to make a commitment to deliver power—and actually make that commitment—before it can receive the benefit of locking in the avoided cost price. 579 A.2d at 1347. In its early cases setting the parameters for determining an LEO, the court held that a legally enforceable obligation was created where a QF had done everything it could to establish an LEO, by tendering a contract to a utility or by petitioning the PUC to approve a contract or compel a purchase, and the only thing that remained was the utility's acceptance or the commission's approval. *Id.*; *Pa. Elec.*, 677 A.2d. 831.

These early cases, however, did not address viability of the project, because viability was not at issue. In *South River Power Partners*, the court upheld the Pennsylvania PUC's decision that a QF had to show viability of a project before establishing an LEO. 696 A.2d at 932. In the underlying docket, the PUC held that substantial action had to be undertaken to acquire the necessary permits, site development approval, construction plans, and financing. 696 A.2d at 931. The PUC found the QF project at issue in *South River Power Partners* was not viable because it had no assets, liabilities, or net worth; did not have a written partnership agreement; did not have employees; had not been associated with any other power production project; had not applied for or obtained any necessary permits or approvals for the project; had not engaged a consultant to assist in obtaining the

required permits and approvals; and had only held discussions with investment bankers but had not received financing for the project. *Id.*

Tennessee

The United State District Court for the Eastern District of Tennessee found that a QF had not incurred an LEO because it was not ready, willing, and able to sell energy to the Tennessee Valley Authority (“TVA”). *Mid-South Cogeneration, Inc. v. Tenn. Valley Auth.*, 926 F. Supp. 1327, 1338 (E.D. Tenn. 1996). In analyzing the facts and comparing them to those in *Smith Cogeneration Management, Inc.*, *supra*, the court stated:

Similarly, in this case, the plaintiff, by asserting a claim for relief under PURPA, in effect asks the court to compel TVA to enter into a contract with Mid-South for the purchase of energy in spite of the fact that Mid-South itself is not bound to deliver energy to TVA, and remains incapable of doing so. The evidence is clear that up to the time of this litigation, the Clinch River facility remained unfinished, not ready to generate electric energy for delivery to the TVA system through the Harriman Utility Board. The evidence is also clear that if the Clinch River facility becomes operable, then the defendant will be prepared to purchase electric energy from the plaintiff in accordance with the defendant’s Dispersed Power Production Guidelines. This is all the relief to which the plaintiff is entitled under PURPA.

926 F. Supp. at 1337.

Wisconsin

In 1992, the Public Service Commission of Wisconsin opened a docket to consider several significant non-utility cogeneration issues in Wisconsin. One of these issues was: what are the attributes of a legally enforceable obligation? The Wisconsin PSC stated the attributes of a legally enforceable obligation depend on the type of project a QF is offering. *Investigation on the Commission’s Own Motion into Barriers to Contracts between Electric Utilities*

and Nonutility Cogenerators and Certain Related Policy Issues, Docket No. 05-EI-112, Findings of Fact, Conclusions of Law & Order (Wis. P.S.C. Dec. 23, 1993). The commission divided QFs into two types of projects: those that required a certificate of public convenience and necessity (CPCN) under Wisconsin law, and those that did not. For QFs that do not need a CPCN, the Wisconsin commission stated that an LEO is created if the QF reaches an agreement with a utility for the sale of electricity. Otherwise, the QF must demonstrate the existence of these basic elements to create an LEO:

- 1) The QF must have done everything in its power to establish with the utility a contract that
 - a. describes the sale of a specific amount of electricity over a specific time span;
 - b. includes a price that is not unreasonable on its face and includes terms and conditions that comply with Wisconsin PSC policy and PURPA; and
 - c. describes a particularly project that is eligible for QF certification from FERC, with an advanced project design and a proposal for an agreement.
- 2) The QF must have made a good faith attempt to resolve as many aspects of the transaction as it could with the utility.
- 3) The QF must have given the utility a reasonable amount of time to review its proposal.

The commission provided additional color as to what would meet these elements. Examples of specific information that would be useful in determining the reasonableness of a QF's attempt to establish a contract included the proposed operations and capacity of the facility; the firmness of the commitment, as shown by guarantees of performance and

risk-reduction assurances; or the status of steam host agreements, fuel purchase agreements, proof of financial viability, and necessary permits. The commission reserved judgment as to what would be a useful benchmark of a reasonable price, but provided examples such as a price offer that is not more than the utility's marginal cost or a price offer that is within 10 percent of the utility's calculation of avoided cost. The QF must show it has received a QF certificate from FERC, meets the requirements for certification, or has applied for a certificate. The question of good-faith efforts to reach an agreement can be answered by looking at the number of meetings between the QF and the utility, the time to respond to offers, and the similarity of terms and conditions to those used successfully elsewhere.

The Wisconsin PSC also found that the following are not required elements of an LEO: plans for interconnections and necessary electrical system modification; proof that the project is at or below avoided cost; proof that the utility would be imprudent not to enter into a contract; a contract offer that is complete in all respects; or an executed purchase power agreement.

Finally, if a QF asks the commission to determine if it has met the LEO standard, the QF must include milestone dates for the following: receiving all necessary permits; signing a steam sales contract; signing a fuel purchase contract; acquiring financing or proof of financial viability; acquiring the site; completing project installation; and commencing operation. Unexcused failure to meet these milestones establishes that the project is no longer viable and invalidates the LEO.

C. This Commission should adopt criteria for the creation of an LEO that protect the QF, the utility, and the utility's customers.

Close examination of the various states' positions reveals that too lax of a standard leads to QFs treating an LEO as nothing more than an option and not actually obligating themselves to do anything. The Commission should avoid a lax standard. The Commission should adopt criteria that include all of the following:

1. an unconditional commitment to deliver energy and capacity at a price no greater than the utility's avoided cost;
2. a date certain for commencement of delivery of energy and capacity and for a term set by the Commission;
3. sufficient guarantees of performance either by the QF having been built or by a performance bond guaranteeing that the project will be built;
4. that a utility and its customers are held harmless from any QF-related liability if the project fails to be constructed or does not operate in the manner expected;
5. written evidence that the developer has obtained all necessary permits, site acquisition, FERC certification as a QF, and financing prior to the creation of an LEO; and
6. a signed interconnection agreement with all milestones agreed to and performance of the milestones by the QF for those occurring prior to the date of the Commission's decision.

These criteria will ensure that a QF that creates an LEO will actually produce and deliver energy to the utility and that the utility can rely on the QF for performance.

D. Oak Tree has not met sufficient reasonable criteria to create an LEO.

The record demonstrates that Oak Tree has not met any reasonable criteria to establish an LEO. Oak Tree has not offered to sell energy at NorthWestern's avoided cost. On a levelized basis, Oak Tree's lowest offer of \$65.44/MWh is almost \$30.00/MWh, or 82.5%, over NorthWestern's avoided cost of \$35.85/MWh.

Oak Tree has not made any unconditional commitment to deliver energy. The Power Purchase Agreement tendered on February 25, 2011, (Lauckhart Direct Test., Ex. 2 ("PPA Ex. 2")) does not obligate Oak Tree to build the project, does not provide mechanical guarantees of the availability of project equipment, and does not contain any guarantees of performance.

PPA Ex. 2 does not include a date certain at which Oak Tree will deliver energy. It does not contain a Guaranteed Commercial Operation Date, which is a standard term in contracts with QFs. PPA Ex. 2 provides for a Commercial Operation Date that "[b]egins at 12:01 a.m. on the day following the day all equipment and interconnection on NorthWestern's side of the Point of Interconnection have reached a degree of completion and reliability, such that in NorthWestern's judgment, Facility is capable of operation continuously and simultaneously to produce and receive power." (PPA Ex. 2, Article 1.3.) This article does not refer to the project, to any of Oak Tree's facilities, or place any obligation on Oak Tree.

Oak Tree's witness, Michael Makens, was asked, "If this Commission determines that NorthWestern Energy's avoided cost is below the rate you offered, the 54.40 plus 2.5 percent escalation, what will Oak Tree do?" (Hr'g Tr. 156:15-17.) He replied, "We'll have

to evaluate if that's financially viable. If we can build it, we will." (*Id.* 156:18–19.) Clearly, Oak Tree can walk away from the project without incurring any liability.

Michael Makens testified that he was familiar with *PPA Ex. 2*, and that he was familiar with the terms in *PPA Ex. 2*. (*Id.* 154:3–7.) However, when asked about mechanical guarantees, Mr. Makens described the document as “a 90-plus page document or something.” (*Id.* 154:14.) Examination of *PPA Ex. 2* reveals that it is just 11 pages.

Michael Makens testified that Oak Tree is registered to do business in the State of South Dakota. (*Id.* 144:2–3.) However, he failed to mention the Certificate of Authority of Limited Liability Company issued by the South Dakota Secretary of State is dated February 21, 2012. Thus, Oak Tree was not even registered to do business in South Dakota on February 25, 2011, when *PPA Ex. 2* was offered to NorthWestern.

Oak Tree has not presented any credible evidence that it has obtained financing for its proposed wind facility. There is no written evidence that any financial institution has agreed to fund the project. In fact, there is no written evidence that Oak Tree has even presented the project to any financial institution.

The record shows that although Oak Tree has a signed Interconnection Agreement, Oak Tree has not met the milestones within that agreement.

Taken together, the facts establish that the Commission should find that Oak Tree has not incurred an LEO.

Conclusion

The record establishes that the best estimate of NorthWestern's incremental cost is \$35.85/MWh. The Commission should not order or authorize any rate to be paid to Oak Tree in excess of \$35.85/MWh.

The record establishes that Oak Tree is free to abandon the project without any liability to NorthWestern. The Commission should find that Oak Tree has not incurred a legally enforceable obligation to deliver energy and capacity to NorthWestern.

For the reasons stated herein, the Commission should dismiss Oak Tree's complaint.

Dated at Sioux Falls, South Dakota, this 18th day of April, 2012.

Respectfully submitted,

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