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

IN THE MATTER OF The Complaint By Oak Tree Energy, LLC Against NorthWestern Energy For Refusing To Enter Into A Purchase Power Agreement	**DOCKET NO. EL11-006** **OAK TREE ENERGY, LLC'S COMBINED REPLY IN SUPPORT OF ITS MOTION FOR PARTIAL RECONSIDERATION OF INTERIM ORDER**

OAK TREE ENERGY, LLC'S COMBINED REPLY IN SUPPORT OF ITS MOTION FOR PARTIAL RECONSIDERATION OF INTERIM ORDER

I. INTRODUCTION

Oak Tree Energy, LLC (Oak Tree), by and through counsel, hereby submits its *Combined Reply in Support of Its Motion for Partial Reconsideration of Interim Order* as follows:

(1) As will be explained in this Combined Reply, Oak Tree believes the "hybrid"

avoided cost methodology adopted by the South Dakota Public Utilities Commission (PUC) is designed to understate a utility's avoided costs, and to discriminate against qualifying facilities (QFs) in violation of the Public Utility Regulatory Policies Act of 1978, 16 U.S.C. § 824a-3 (PURPA). NWE Energy (NWE) and PUC Staff (Staff) have both argued in their respective responses that the hybrid methodology is appropriate due to the manner in which NWE operates its utility. However, assigning the incremental value of NWE's coal-fired generation in hours NWE has more low cost coal than is needed to serve NWE's native load does not reflect how NWE actually operates its generation. Instead, all parties admit that, instead of backing down its coal-fired generation in hours it has more low cost coal than is needed to serve NWE's native load, NWE sells generation into the market to capture whatever value it can. Thus, the hybrid methodology does not accurately reflect what NWE actually does – instead, it assigns an artificially low number to Oak Tree in hours NWE has more low cost coal than is needed to serve NWE's native load. Essentially, it is a fiction that NWE and Staff claim is reality, but it does not reflect the manner in which NWE operates its resources. Moreover, the argument continues to be made that when NWE has more low cost coal than is needed to serve NWE's native load, NWE is making sales and these are revenues and not costs. However, both Staff and NWE completely ignore the argument in their response that from a resource-load balance standpoint, when a QF purchase is made, some resource must necessarily be displaced. Thus, a resource is being avoided in those hours. Finally, the hybrid methodology would permit NWE to pay Oak Tree less in those hours when NWE

has more low cost coal than is needed to serve NWE native load than NWE would pay itself. NWE paying Oak Tree less than it pays itself is plainly discriminatory treatment; there is no other way to describe it.

(2) NWE's primary argument for the use of "current" information is that it has filed an Application for Reconsideration (NWE's Application) on the issue of whether Oak Tree established a legally enforceable obligation (LEO) as of February 25, 2011. However, if the PUC decides that NWE's Application on this issue is without merit (and it is, as set forth herein and in Oak Tree's separately filed answer to NWE's Application), even NWE implicitly does not argue that PURPA permits reliance on information that only existed after the creation of Oak Tree's LEO on February 25, 2011. Staff agrees that use of post February 25, 2011 information would be inappropriate. NWE argues that Oak Tree witness Lauckhart ignored or missed information that was available to him as of February 25, 2011 but this less than charitable interpretation of Mr. Lauckhart' s testimony is simply false. Mr. Lauckhart did not say that Black & Veatch produced its Spring Energy Market Perspective in February; he said he saw no reason to change the natural gas price forecast *as of* February. The Black & Veatch Energy Market Perspective is prepared twice a year. Mr. Lauckhart relied on the November 2010 Fall Energy Market Perspective. Mr. Lauckhart testified the Black & Veatch perspective was prepared twice a year, and since it was only three months previous that Black & Veatch had prepared its perspective, the Black & Veatch Spring 2011 Energy Market Perspective was not, in fact, available until well after February 25, 2011. Yet, NWE attempts to smear Mr. Lauckhart with the argument that he intentionally

ignored this information without the slightest evidence that any of the information was, in fact, information that he did not consider or that he had available to him when he prepared the avoided cost forecast for Oak Tree. NWE makes much of the fact that the Waxman-Markey cap and trade legislation has languished in Congressional purgatory, but ignores the fact that the United States Circuit Court of Appeals for the District of Columbia on June 26, 2012, upheld the U.S. Environmental Protection Agency's (EPA) finding that carbon emissions endanger human health and the environment as well as EPA's rules implementing carbon emission regulation of stationary sources. *See Coalition for Responsible Regulation, Inc. et al. v. EPA*, --- F.3d ----, 2012 WL 2381955 (D.C.Cir. June 26, 2012) (Attached as Exhibit 1). The Court of Appeals also emphasized that the U.S. Supreme Court in *Massachusetts v. EPA,* 549 U.S 497 (2007) previously ruled that EPA not only has the jurisdiction to regulate carbon emissions as a potential air pollutant under the Clean Air Act, but the obligation to do so. The EPA complied with the U.S. Supreme Court's directive in finding that carbon emissions were a potential danger to human health and the environment, and adopted regulations for greenhouse gas emissions. The Court of Appeals upheld EPA's regulations. In light of these decisions, for NWE to continue to claim that there should be no cost assigned to carbon emissions is to simply ignore reality. And, consonant with Staff's testimony, a very high probability should be assigned to the risk that greenhouse gas regulations will substantially increase the cost of thermal based generation resources in the United States, including South Dakota. Given the potentially draconian costs that the EPA might choose to impose under its own

authority, a significant question remains; whether Congress will act to adopt a program similar to Waxman-Markey's cap and trade proposal effectively preempting EPA's regulations. Regardless of congressional action, there will be carbon regulation of some sort, and it will likely be costly. For NWE to pretend that carbon emissions will have no cost in the future is contrary to these facts.

II. REPLY TO NORTHWESTERN ENERGY'S ANSWER

A. Executive Argument

The "hybrid" methodology is not really a methodology at all. Instead, it is a result oriented mechanism which systematically lowers a utility's avoided cost by relying on the market when doing so lowers avoided costs, but relying on the utility's own resources when that method reduces avoided costs. The QF, in this case Oak Tree, is disadvantaged because there is no question that NWE's own resources in heavy load hours are more costly than the market. Similarly, the QF is disadvantaged in light load hours because the incremental cost of operating NWE's own resources – in this instance, its coal plants – is less costly than the market which NWE freely takes advantage of in those hours. The issue of whether the market in such situations is a "cost" or "revenue" is irrelevant – the market either exists and it forms the basis for avoided costs or it does not. Using either the utility's own resources as the basis for avoided cost or the market would be fine. But to systematically understate avoided costs by utilizing a method which disadvantages the QF is unlawful. Nor is the argument that there are no costs "avoided" when market sales are made during light load hours persuasive. From a resource stack perspective, the market is where the incremental activity takes place and sets the avoided cost. A resource somewhere is displaced by the utility's purchase from a QF.

The use of current information is plainly contrary to dictates by PURPA. NWE offers nothing but the argument that this issue is moot if there was no LEO created on February 25, 2011. Moreover, its argument that Mr. Lauckhart ignored information is belied by the facts. Mr. Lauckhart considered all the resources available to him as of that date. Finally, NWE's argument on carbon costs is plainly insupportable. NWE is simply attempting to discriminate against QFs by proposing to pay them nothing for avoided costs associated with greenhouse gas mitigation or, alternatively, pay them substantially less for carbon costs than NWE has proposed in the Spion Kop proceeding. NWE argued in that proceeding, MPSC Docket 2011.5.41, that it would be imprudent for a utility planner not to include such costs. In this Docket, NWE claims that Waxman-Markey is dead (after relying on that bill and the Northwest Power Conservation Council's (NWPCC) 2009 forecast), and therefore no carbon costs should be included. This is plainly an example of discrimination by NWE against Oak Tree.

B. Argument

1. NWE's Argument on the Hybrid Methodology is Misleading and Contrary to PURPA.

NWE argues, as does the Staff, that Oak Tree is mistaken about its reading of PURPA because the "hybrid" methodology more appropriately captures the way that NWE operates its system in South Dakota and the sales that NWE is making do not represent "costs" avoided but revenue received. NWE's argument is misplaced for several obvious reasons. First, it ignores the "incremental" activity that actually takes place in favor of a hypothetical world that does not exist. NWE does *not* shut down its base load coal plants in hours where NWE has more low cost coal than is needed to serve NWE's native load; rather it sells the

power from its coal plants in those hours. As a result, NWE is able to obtain revenue from those hours instead of having to back down its generation.

Second, the "revenue" that NWE derives in the hours that it has more low cost coal than is needed to serve NWE's native load is actually a part of NWE's avoided costs. When NWE makes a sale instead of backing down its own generation, the revenue that NWE makes from those sales is used to offset the costs of its own generation. The cost of that generation is not a loss, therefore, in the hours that the plants are operating. Instead, those costs are *avoided* by NWE making sales in those hours. As noted previously, Mr. Lauckhart's market methodology approach does not use the incremental cost of operating NWE's generation as a "floor" on NWE's avoided costs. Instead, Mr. Lauckhart's market methodology recognizes that there will be times when market is *lower* than the avoided cost of operating NWE's resources and that lower value is assigned to Oak Tree. However, Mr. Lauckhart also appropriately recognizes that in most hours, the incremental costs of operating NWE's coal plants is lower than market and properly assigns those market values to Oak Tree. Mr. Lauckhart also uses the market rather than the incremental cost of operating gas fired resources when the market is lower than the cost of operating those gas fired resources.

Third, when NWE makes a sale to the market, NWE is avoiding a cost because a transaction is made whereby another sale, displaced by Oak Tree, is avoided. This argument addresses both NWE's and Staff's argument that NWE does not *avoid* anything when it gets QF power in hours when its coal plant is already sufficient to meet its load. As stated in Oak Tree's motion for reconsideration, NWE's and the Staff's argument is based on a misunderstanding of the PURPA avoided cost concept. From a load/resource balancing perspective, it is clearly the case that when additional power is injected into the system, some

other resource or source of generation needs to be backed down. In this case, there is a specific resource or source of generation on the system that is plainly avoided by NWE's sale of generation into the market. In other words, the addition of Oak Tree will result in some generation resource being backed down that would otherwise have injected power into the market. Thus, the incremental activity and the costs associated with the activity takes place in the market, not in a hypothetical world where NWE is backing down its coal plants rather than making such sales. Make no mistake, whenever NWE is making such sales rather than backing down its own generation, there is some resource that is being backed down in order to accommodate this sale. Put plainly, the avoided resource does not have to be a resource that NWE owns or controls. When a utility is interconnected with a larger grid, the universe of resources that can be backed down is greater than the sum of the utility's own generation.

As stated in Oak Tree's motion for partial reconsideration, a prudent scheduler would recognize that more costs can be avoided if a resource other than that owned by NWE on the grid is backed down. What NWE is actually avoiding by purchasing from Oak Tree in that situation is the operating cost of this alternative generation that is not scheduled due to the purchase from Oak Tree. The costs avoided in that situation are the transfer of value from NWE to the third party entity which is then displaced by Oak Tree. Thus, the generation costs being avoided when NWE gets additional power on hours when its coal plants are sufficient to meet its load occurs from the backing down of generation from other non-NWE generation on the grid.

Fourth, there is no question that permitting NWE to pay Oak Tree less for its generation in the hours when NWE has more low cost coal than is needed to serve NWE's native load is discriminatory. There is no dispute that under the hybrid methodology, NWE

will obtain a higher value from the market for the power that will be sold to NWE by Oak Tree. Thus, there is also the very real possibility that NWE will resell Oak Tree's power at a price far above the incremental costs of operating NWE's coal plants, thereby creating a potential for a windfall by NWE. How and why NWE should be permitted to collect more revenue in the hours that it has more low cost coal than is needed to serve NWE's native load than it proposes to pay Oak Tree is not adequately explained by either Staff or NWE.

A proper avoided cost methodology would utilize the market in all hours, including when NWE has more low cost coal than is needed to serve NWE's native load. Ignoring the market in only the hours NWE has more low cost coal than is needed to serve NWE's native load guarantees that Oak Tree will be paid less for its power than the value obtained by NWE. Alternatively, if the PUC chooses a methodology which does not rely on the market in hours NWE has more low cost coal than is needed to serve NWE's native load but instead on the incremental cost to operate NWE's resources, to be consistent and fair to Oak Tree, that methodology should be applied across all hours including those where NWE does not have enough low cost coal to meet its load and would need to run its gas fired resources in the absence of a market. NWE's gas fired peaking resources are more expensive than the market in the hours NWE does not have enough low cost coal to meet its native load. Although NWE claims its peaking resources are operated only rarely, this is hardly the point. NWE rarely operates these resources because it has access to a market. If the market did not exist, as NWE and PUC staff hypothetically posit only in the hours NWE has more low cost coal

than is needed to serve NWE's native load, NWE would be operating those expensive peaking resources in hours when NWE is short.[1]

Oak Tree contends that a proper application of the full avoided cost principle would recognize that the market exists and sets the price both in hours that NWE has more low cost coal than is needed to serve NWE's native load and when NWE does not have enough low cost coal to serve NWE's native load. If the PUC wishes to pretend the market does not exist, it should pretend the market does not exist and rely solely on the incremental cost of NWE's resources in all hours. However, what the hybrid method does is discount the value of NWE's generating resources to the market value that NWE pays in in all hours when NWE does not have enough low cost coal to serve NWE's native load, while simultaneously discounting the value of the market to the incremental cost of operating NWE's generating resources in hours that NWE has more low cost coal than is needed to serve NWE's native load. This is plainly a "heads we win, tails you lose" methodology, which systematically discounts NWE's actual cost of generation below its avoided costs. This is plainly unlawful under PURPA.

The question remains, by its order did the PUC intend to ignore reality and the existence of market only in the hours when NWE has more low cost coal than is needed to serve NWE's native load while simultaneously using the market when NWE is does not have enough low cost coal to serve NWE native load? Either the market is the appropriate

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[1] NWE also offers the strained argument that because it does not schedule its own resources, WAPA does, that WAPA is responsible for dispatching resources in economic order and NWE has no control over the dispatch of its peaking units. *NWE Answer Br.* at 4. Presumably, this is an argument that since WAPA is dispatching resources, purchasing from Oak Tree will not change this order of dispatch. This is true as far is it goes, but does not change the avoided cost of the plants involved or the relative cost of the market. As such, whenever QF power goes into the WAPA system, the order of dispatch will change and a more expensive resource will be displaced by the QF power. This is precisely Oak Tree's argument for why a market based approach to avoided costs is more appropriate than the hybrid methodology which does not reflect the economic order of dispatch of resources by WAPA.

benchmark for avoided costs or it is not, and NWE's cost to operate its resources in all hours is the appropriate measure. For the PUC to choose to use the market only in hours that it will artificially reduce NWE's avoided costs is a plain violation of PURPA.

The cases cited by NWE for the proposition that it is permissible to ignore the market sales from a utility's own generation in calculating avoided costs when it has more low cost coal than is needed to serve NWE's native load (while simultaneously using the market to understate NWE's avoided costs when it does not have enough low cost coal to serve NWE's native load) do not support use of the hybrid methodology. *See NWE Answer Br*. at 3, n. 5. The first case cited by NWE is *In re Entergy Arkansas Inc.(EAI)*, Docket No. 04-113-U, Order 18, 2008 WL 495538, at *10 (Ark. P.S.C. Jan. 15, 2008). First, unlike the facts in this proceeding, the *Entergy* decision dealt with existing QF contracts that did not require a forecast of avoided cost. Instead, the Arkansas commission was making an after the fact (based on known generation figures) hourly avoided cost determination of rates to be paid to existing QFs. Second, the avoided cost calculations in that proceeding took into account a much larger market than just that served by the utility (EAI) since it reflected the incremental costs of all resources in the greater Entergy Corporate family. Third, the Arkansas commission was concerned that these "after the fact" hourly calculations might lead EAI to stop making secondary sales if the value of the secondary sales was provided to QFs. In contrast, in this proceeding Oak Tree is exercising its right to request a forecast avoided cost calculated over the life of a 20-year term instead of an after the fact hourly determination of avoided cost as in the *Entergy* proceeding. Furthermore, unlike the Entergy proceeding, no prudent utility would stop making economy sales that generated revenue simply because a forecast of avoided costs reflected the value of secondary sales, and there is no sensible

reason the utility would do so. Simply put, the *Entergy* proceeding has nothing whatsoever to do with the hybrid methodology proposed by NWE in this proceeding.

The Virginia commission also dealt with a vastly different issue than the "hybrid" methodology in *In re Virginia Elec. & Power Co*., Case No. PUE980463, 2000 WL 1510083, at *4 (Va. S.C.C. July 28, 2000). First, Virginia Electric & Power used the differential revenue requirement model, whereby the utility runs the ProMod hourly dispatch model of its system with and without a block of power. The differential total power costs when removing the block of power is the basis for the utility's avoided cost. Virginia Electric & Power did not use any market (for excess power or otherwise) in its resource stack because the utility did not utilize the "economy interchange" transaction module for ProMod – which shows market prices for spot purchases and sales.

The Virginia commission acknowledged the market might be a better way to calculate avoided costs in the future, but decided not to do so in this proceeding and instead relied solely on the avoided cost associated with the utility's own resources. Oak Tree would be content relying on the incremental value of NWE's own resources in South Dakota in calculating an avoided cost. Put simply, the *In re Virginia* decision did not deal with the situation advocated by both NWE and Staff here, whereby avoided cost is systematically reduced by using a market value only in hours when it reduces avoided costs, but not using a market value in hours when it would increase avoided costs. Again, there is simply no state commission that is or would approve such a methodology, as it blatantly violates PURPA. Thus, the PUC should grant Oak Tree's motion for reconsideration.

2. Use of Current Costs Would Violate PURPA

NWE argues initially that because it has filed an Application for Reconsideration on the LEO issue, if the PUC grants NWE's Application, this issue is moot. Apparently, if the issue of use of current information is not moot because the PUC disagrees with NWE's Application for Reconsideration on the LEO issue, NWE apparently intends to rely on the argument that Mr. Lauckhart was "either unaware of or deliberately failed to consider" certain information NWE claims was available to Mr. Lauckhart as of February 25, 2011. *NWE Answer Br.* at 6.

First, note that NWE's argument on the use of current information completely sidesteps the issue of whether the use of current information would be appropriate if the PUC declines to reconsider its earlier finding that an LEO was created as of February 25, 2011. In other words, what NWE is attempting to do is argue whether Mr. Lauckhart's avoided cost forecast was accurate as of February 25, 2011, not whether it would be appropriate for the PUC to base avoided costs on information only available after February 25, 2011. Thus, Oak Tree presumes that NWE agrees that in the event the PUC affirms its earlier finding that an LEO was created as of February 25, 2011, no avoided cost information available subsequent to that date should be considered by the PUC in setting avoided costs for Oak Tree.

Second, the arguments that NWE makes in its response that Mr. Lauckhart was either "unaware" or "deliberately failed to consider" information available as of February 25, 2011 is precisely the debate that will take place if the PUC reconsiders its interim order with respect to the use of "current" information. NWE is free to introduce evidence and argument that Mr. Lauckhart's avoided cost calculations did not adequately consider relevant information available to him as of February 25, 2011. However, NWE's argument has

nothing to do with whether the PUC should permit the use of information in calculating avoided costs for Oak Tree that was unavailable to Oak Tree as of February 25, 2011.

Third, NWE's argument is plainly false. There is no evidence in the record that Mr. Lauckhart failed to consider the "game changing" EIA report of November 30, 2010. Mr. Lauckhart's calculations relied on the Black & Veatch report and he considered the fact that EIA, among other forecasting entities, had forecast increased natural gas reserves. In fact, contrary to NWE's factually incorrect claim, Mr. Lauckhart testified at hearing that he had expressly considered the EIA forecast in calculating avoided costs for Oak Tree:

> Q. [Mr. Uda] Were you present for Mr. Rounds' testimony that he believes you should have done in February of 2011 taken another look at gas prices to include in your model, for example, the EIA forecast?
>
> A. [Mr. Lauckhart]Yes.
>
> Q. Okay. Do you have a reaction to that?
>
> A. Yeah. I think that that is a good thing to think about. And in the industry we do this. You do a forecast, came out in November. February rolls -- you're not going to plan to do it again until another six months. But you continue to monitor the situation. If it's moved significantly that you would think oh, man, maybe I better redo it because people are relying on this, because things have changed enough that it might make a difference, you would. But to tell you the truth in February it had not moved enough. It just had not moved enough.

EL11-006 Hr'g Tr. 503:2-18.

Thus, NWE's claim is false. In addition, Mr. Lauckhart consulted with other experts at Black & Veatch about, among other things, the validity of the EIA forecast. Among the concerns expressed was that EIA did not retire any coal plants in their forecast which would have a long term effect on natural gas prices. EL11-006 Hr'g Tr. 504:6-505:5.

NWE also claims that the Black & Veatch Spring 2011 forecast was available to Mr. Lauckhart in February of 2011, and that he failed to consider natural gas liquids. *NWE*

Answer Br. at 6. First, Mr. Lauckhart emphatically did *not* testify that the Black & Veatch Spring 2011 forecast was available to him as of February 2011:

> Q. [Mr. Soye] And that this market perspective is released twice a year?
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> A. [Mr. Lauckhart] We update it twice a year. We found -- we've found that in the industry most people think that's refreshed soon enough. You know, two days after we've released nobody's suggesting you change it, you know. The month and a half nobody's suggesting you change it. Occasionally, something large happens when we would change it before six months was up. *But in this case we didn't see that in February of 2011.*

EL11-006 Hr'g Tr. 87:25-88:13 (Emphasis added).

Mr. Lauckhart actually testified that the Black & Veatch Energy Market Perspective is issued twice a year, and that there was no reason to redo the November 2010 Energy Market Perspective as of February 2011. There is no support in the record for NWE's insinuation that Mr. Lauckhart ignored the Black & Veatch Spring 2011 Energy Market Perspective when he prepared his avoided cost forecast for Oak Tree in February of 2011. According to the document's properties in Word, the document was created in September of 2011. Although Oak Tree does not know when the forecast was actually made public, Mr. Lauckhart plainly did not say the Spring Energy Market Perspective was available as of February 2011. In fact, he said that there was no reason to redo the market perspective in February of 2011, and he consulted other experts at Black & Veatch regarding this conclusion.

NWE also argues that Mr. Lauckhart failed to consider that the Waxman-Markey Bill was dead. *NWE Answer Br.* at 6. In point of fact, Mr. Lauckhart discussed that although this bill was dead; Black & Veatch considered this fact but believed something like the Waxman-Markey cap and trade approach would ultimately be adopted:

> *And our belief is that will probably be close to what gets passed if ever anything gets passed by Congress. And we think it probably will be. Although now we're thinking it's going to be delayed so implementation will be after*

> *2016.* Suffice it to say, we do a considerable amount of work showing, well, what is the cap and what are the ways to meet the cap and go through the math, supply and demand, of figuring out how you're going do that – this is what cap and trade is all about -- and what we think a market clearing price will be that allows us to meet the cap.

EL11-006 Hr'g Tr. 89:8-19 (emphasis added).

So Mr. Lauckhart did consider – along with Black &Veatch – that the Waxman-Markey bill had not been passed. But Mr. Lauckhart and Black & Veatch also believed that cap and trade would eventually be the sort of legislation that is passed, and did their best to model that cost. This is plainly contrary to NWE's assertion that Mr. Lauckhart failed to consider cap and trade was dead.

Mr. Lauckhart's belief that carbon costs should not be zero was recently bolstered significantly by the U.S. Court of Appeals for the D.C. Circuit's decision in *Coalition for Responsible Regulation, Inc. et al. v. EPA*, --- F.3d ----, 2012 WL 2381955 (D.C.Cir. June 26, 2012) (Exhibit1, attached). In that decision, the D.C. Circuit rejected all challenges to EPA's authority to regulate greenhouse gases, including all challenges to EPA's finding that greenhouse gases endanger human health and welfare:

> To recap, EPA had before it substantial record evidence that anthropogenic emissions of greenhouse gases "very likely" caused warming of the climate over the last several decades. EPA further had evidence of current and future effects of this warming on public health and welfare. Relying again upon substantial scientific evidence, EPA determined that anthropogenically induced climate change threatens both public health and public welfare. It found that extreme weather events, changes in air quality, increases in food- and water-borne pathogens, and increases in temperatures are likely to have adverse health effects. The record also supports EPA's conclusion that climate change endangers human welfare by creating risk to food production and agriculture, forestry, energy, infrastructure, ecosystems, and wildlife. Substantial evidence further supported EPA's conclusion that the warming resulting from the greenhouse gas emissions could be expected to create risks to water resources and in general to coastal areas as a result of expected increase in sea level. Finally, EPA determined from substantial evidence that

> motor-vehicle emissions of greenhouse gases contribute to climate change and thus to the endangerment of public health and welfare.

Id. at * 9.

The Court upheld these findings as supported by substantial evidence. *Id.* Furthermore, pursuant to this endangerment finding, EPA promulgated a regulation that will require construction and operating permits for stationary sources under the provisions of the Clean Air Act. *Id.* at * 24. The D.C. Circuit also upheld this determination by EPA as a matter of law. *Id.* Thus, the risk that greenhouse gas emissions will be regulated is not only very real, it is in fact imminent. For NWE to continue to claim that zero costs should be assigned to the cost of carbon-related emissions is not only incorrect, it flies in the face of all recent EPA actions and subsequent Court approval of those actions. Stationary sources will be regulated by EPA, unless and until Congress acts.

Whether Congress ultimately adopts the cap and trade approach in legislation as proposed by Waxman-Markey is beside the point. Unless the Clean Air Act is significantly amended by Congress, EPA will be regulating greenhouse gas emissions and these will take the form of potentially very costly construction and operating permits for stationary sources. These costs must be taken into account, and, in this case, they are not taken into account in any manner by NWE or any of its witnesses.

Finally, NWE attempts to rehabilitate the carbon cost estimates made by Steven Lewis of Lands Energy. *NWE Answer Br*. at 7. Mr. Lewis' carbon estimates are, as Staff notes, not based on any real record evidence. Instead, it appears Mr. Lewis simply consulted his colleagues at Lands Energy. EL11-006 Hr'g Tr. 89:20-22. Mr. Lewis' simple approach to carbon costs is not supported by any credible analysis by any reputable forecasting agency,

including the Northwest Power & Conservation Council's 6th Forecast, the EIA, or Black & Veatch.

The PUC cannot use "current information" if an LEO was established as of February 25, 2011, which the PUC appropriately found in its May 15, 2012 interim order. To use current information would violate PURPA. Oak Tree's motion for reconsideration should be granted.

3. NWE's Carbon Cost Estimates In this Proceeding Are Unreliable and Discriminatory

NWE offers three arguments for why it has chosen to blatantly discriminate against Oak Tree in South Dakota while offering a completely different approach to incorporating carbon costs for its own project in Montana. However, at the outset, Oak Tree notes that NWE utterly fails to address the indisputable fact that any carbon costs imposed either by EPA or by eventual congressional action will result in a national policy that will apply equally in South Dakota and Montana.

NWE first argues, without any legal support or logical basis, that there is a difference between utility planning documents and a proper calculation of avoided costs. First, the Montana Supreme Court has expressly held that avoided costs are to be based on NWE's Electricity Supply Resource Procurement Plan (EPP). In Montana, the Montana Supreme Court held:

> The PSC requires utilities to submit avoided cost data every other year within thirty days of submitting an integrated least cost resource plan. Admin. R.M. 38.5.1905, 2012. *Thus, under both state and federal law, rates for purchases from qualifying facilities must be reasonable and based on current avoided least cost resource data. Independent Energy Producers Ass'n v. California Pub. Utils. Comm'n,* 36 F.3d 848, 851-852 (9th Cir.1994); 18 C.F.R. § 292.304; § 69-3-604, MCA.

Whitehall Wind v. Montana Public Serv. Com'n, 355 Mont. 15, 19, 223 P.3d 907, 919 (2010) (emphasis added). Thus, regardless of whether NWE believes that its EPP is simply a planning document, the EPP was the basis for the carbon costs which NWE used in Montana to justify its decision to acquire the Spion Kop wind project. The EPP is the NWE "integrated resource plan" in Montana. Thus, NWE's avoided costs must be based by law on the EPP planning document regardless of whether NWE believes they should be based on this document.

Nor do any of NWE's elaborate explanations for its apparent discriminatory treatment of Oak Tree – which essentially amount to a complaint that the Montana PSC ordered NWE to include carbon costs in its EPP – explain away NWE's decision to use the Northwest Power and Conservation Council's Sixth Plan for calculating carbon costs in Montana but not South Dakota. The Montana PSC did not *order* NWE to acquire Spion Kop. The Montana PSC did not *order* NWE to use the NPCC's Sixth Plan's carbon costs to justify NWE's acquisition of Spion Kop. NWE made those decisions, which it now attempts to explain away without any convincing justification for this glaring inconsistency.

However, during the Spion Kop proceeding, NWE witness Mr. Guldseth explained that he felt it would be imprudent not to include carbon costs in the calculations used to justify NWE's acquisition of Spion Kop:

> And I think it would be imprudent for us, as planners, to not consider, not necessarily legislation that might be passed that could impact a price forecast such as I've developed here, but there could be other factors, capital costs to bring existing resources into compliance. And it may not be legislative, it may be the threat of legislation that causes utilities to act in that manner. But the resulting impact will flow through to a forecast to prices in consumer retail rates.

Cross Examination of Todd Guldseth, Montana PSC Docket D2011.5.41 Hr'g Tr. 46:24-47.

The hearing on Spion Kop was a scant 97 days before the hearing in this proceeding. It was plainly prudent and reasonable to include carbon costs in the acquisition of NWE's own resource, but less than three months later it somehow became wildly inappropriate to do so when calculating an avoided cost for the Oak Tree project.

Also, NWE's argument on the distinction between a planning document and an avoided cost calculation makes little sense. In order to know what resources may be avoided by the purchase from a QF, one must know what the utility plans to acquire in the future. There is and must be a relationship between the utility's planning documents and avoided cost.

NWE also takes issue – again – with the idea that carbon costs could be based on the Waxman-Markey cap and trade legislation. This argument is addressed above. Whether one chooses to base carbon cost estimates on a cap and trade approach or whether it is based on the cost of thermal resources obtaining construction and operating permits that include a requirement to limit greenhouse gas emissions, there is simply no basis for assuming that there will be no cost associated with greenhouse gases in the future. Since Waxman-Markey passed the United States House of Representatives, Black & Veatch reasonably used that approach in calculating potential costs associated with expected future greenhouse gas legislation.

Finally, NWE argues it cannot evaluate the EIA forecast that was identified as Exhibit 1 in Oak Tree's motion for reconsideration. Oak Tree mislabeled that Exhibit which should have been identified as Exhibit 2 to its motion for reconsideration. However, the information was included along with its motion for reconsideration and is properly identified in the exhibits as Exhibit 2. Oak Tree apologizes for any confusion its error may have caused.

However, it does not change the fact that the NWPCC's Sixth Plan, the Black & Veatch 2010 forecast, and the 2011 EIA forecast are far more reliable than anything produced by Lands Energy.

Oak Tree notes that NWE does not defend Lands Energy's carbon forecast with some evidence or analysis as to why it is superior to EIA, Black & Veatch, or the NWPCC's Sixth Plan. It is especially interesting that NWE was not advocating the use of anything other than the NWPCC's Sixth Plan during the Spion Kop proceeding, but seems to lack enthusiasm for the NWPCC's forecast of carbon costs when it is not calculating the value of its own resource.

NWE also argues that Oak Tree abandoned its argument that information only available after February 25, 2011 should not be used in calculating avoided costs because Oak Tree references carbon cost information testified to by Mr. Guldseth in the Spion Kop case. However, the carbon costs that NWE utilized in the Spion Kop proceeding were based on the *2009* NPCC average carbon cost case that existed *prior* to the LEO date of February 25, 2011. This much is clear from Volume 1, Chapter 4 of NWE's own EPP. "In its 2009 RPP, NorthWestern adopted the Northwest Power and Conservation Council's (NWPCC) average carbon tax from its 6th Power Plan as the base case for carbon taxes." *See Oak Tree's Answer to NWE's Application for Reconsideration*, Exhibit 1, p. 86. "In the interim between plans, NorthWestern has found no better information that would cause it to move away from using the NWPCC's forecast values." *Id.* at pp. 87-88. Thus, Oak Tree is not being inconsistent in relying on Mr. Guldseth's testimony in the Spion Kop proceeding. The NPCC forecast from 2009 was the basis for Mr. Guldseth's calculations, and this forecast is substantially higher than the forecast by Lands Energy.

In conclusion, NWE is plainly offering a carbon cost approach that is discriminatory. NWE may claim it is not, but there seems little policy or legal justification for this differential treatment of Oak Tree as a QF from the manner in which NWE calculated carbon costs for its own facility. This national policy will be uniformly enforced, whether by a cap and trade legislative approach such as Waxman-Markey, or simply through EPA enforcement of its greenhouse gas regulations. The fact is that carbon costs are real, and the only question for the PUC is what is the best estimate of those costs? Even NWE did not think Lands Energy's forecast prepared in October of 2011 was more reliable than the NWPCC when it sought approval of the Spion Kop acquisition before the Montana PSC.

The PUC should grant Oak Tree's motion for reconsideration and reopen the record to include consideration of an alternative to the Lands Energy forecast. To do otherwise would be to ignore the best evidence available to the parties as of February 25, 2011, including information relied upon NWE in justifying its decision to acquire the Spion Kop resource.

III. REPLY TO COMMISSION STAFF'S ANSWER

A. Executive Argument

Staff's argument on the hybrid methodology is inconsistent with how NWE actually operates. NWE does not back down its generating resources when it has more low cost coal than is needed to serve NWE's native load in order to avoid incurring costs. Instead, NWE sells its generation into the market. Oak Tree is advocating a method whereby either the costs of NWE operating its own resources in all hours is relied upon in calculating avoided costs or, alternatively, the market is exclusively relied upon in calculating NWE's avoided costs. Where Oak Tree believes the hybrid methodology violates PURPA is the picking and choosing of NWE's resources when doing so lowers avoided cost, and picking the market

when doing so lowers avoided costs. Neither NWE nor the Staff has denied that this is actually the case. With respect to the use of current information, Staff agrees with Oak Tree that using current information would violate PURPA. Finally, Staff agrees with Oak Tree that Steven Lewis' carbon costs of $5/$10/$15 appears to be based on little other than surmise, and should not be used as the basis for calculating carbon costs.

Staff also appears to agree that Oak Tree has provided a carbon cost analysis in this proceeding that is actually based on proposed legislation, but that the costs associated with that legislation were not appropriately discounted by the probability the legislation will be passed. However, Staff does not appear to be aware that the carbon costs testified to by both NWE in the *Spion Kop* proceeding, MPSC D2011.5.41, and by Mr. Lauckhart (based on Black & Veatch's 2010 Fall Market Energy Perspective) were already discounted by moving back the effective date of the legislation and the costs associated with adoption of that legislation using the Waxman-Markey cap and trade legislation as the model. Second, the recent D.C. Circuit Court of Appeals decision, *Coalition for Responsible Regulation, Inc. et al. v. EPA*, --- F.3d ----, 2012 WL 2381955 (D.C.Cir. June 26, 2012) (Exhibit 1, attached), makes it clear that EPA must regulate greenhouse gas emissions even in the absence of congressional action, and EPA has already adopted regulations adopting construction and operating permits for stationary sources.

B. Argument

1. Staff's Argument Regarding the Hybrid Methodology Fails to Comport with Reality

The Staff opposes Oak Tree's motion for reconsideration of the hybrid methodology because: (1) it reflects NWE's actual operations in South Dakota as a vertically integrated

utility; (2) because at times when NWE has more low cost coal than is needed to serve NWE's native load if it does not purchase output from Oak Tree, it will satisfy its load requirements with its own internal generation; (3) when NWE does not have enough low cost coal to serve NWE's native load it actually makes purchases instead of operating its peaking units.

NWE's status as a vertically integrated utility is irrelevant to the issue of its avoided costs. Understandably, Staff contends that because NWE often has sufficient low cost coal resources to meet its load, NWE's actual operations should govern its avoided costs. However, Staff ignores the fact that this is not what NWE is actually doing – NWE will not displace its own generation in hours that it has more low cost coal than is needed to serve NWE's native load by backing down its generation. Instead, prudently, NWE makes sales into the market. This market is the benchmark for avoided cost since the utility is simply reselling its generation into the market when it is has more low cost coal than is needed to serve NWE's native load rather than backing down its coal fired generation.

Thus, Staff's second argument is also flawed because NWE is not going to displace its own low cost coal generation with QF purchases – there is no evidence this is so, and appears to be more fiction than reality. Whenever NWE has more low cost coal than is needed to serve NWE's native load, it makes sales into the market to obtain the best price it can for its power. Undoubtedly, if NWE can make a gain by reselling QF generation in the market, it will take advantage of this. What Staff is actually advocating is a system where NWE may arbitrage Oak Tree's power by getting it at the incremental cost of NWE's own generation, and thereafter making a gain by selling it into the market. To treat Oak Tree differently than NWE's own resources would be illegal discrimination under PURPA.

Third, Oak Tree's point is that when NWE does not have enough low cost coal to serve NWE's native load Oak Tree could pretend – as Staff does when NWE is long on coal – that the market does not exist. Oak Tree is not advocating pretending the market does not exist, only that the PUC assume the market exists in all hours – not just those hours that drive down NWE's avoided costs.

Like NWE, Staff does not really address Oak Tree's argument that in the hours when NWE has more low cost coal than is needed to serve NWE's native load, the incremental activity that takes place in the resource stack does not take place at the level of the incremental cost of operating NWE's coal plant. Some resource is avoided, but it is not NWE's resources because those are often well below the market price for electricity. Oak Tree is also not arguing that the incremental cost is a floor for avoided cost, assigning whatever value to Oak Tree's generation the market will bear, even if that price is well below NWE's incremental cost of operating its coal plants.

Oak Tree understands that Staff favors the hybrid methodology, but it is not really a methodology as much as it is a way to systematically understate avoided costs by picking and choosing the lower of market or NWE's incremental cost to operate its plants. Staff may contend that this methodology comports with reality, but in fact it does not. NWE is not backing down its coal fired generation during hours that it has more low cost coal than is needed to serve NWE's native load, but rather reselling it into market. Thus, under this hybrid methodology, NWE is earning substantially more for its own power than it proposes to pay Oak Tree. It is hard to see how such differential treatment would not be discriminatory and thus a violation of PURPA. As such, Oak Tree's motion for reconsideration of the hybrid methodology should be granted so as to avoid an unlawful result under PURPA.

2. Staff is Correct that PURPA Requires the Use of Information Available when the LEO is Created

Staff agrees with Oak Tree's motion for reconsideration that the use of "current information," which would mean, in this context, information available after the formation of the LEO on February 25, 2011, would be improper under PURPA. Staff's analysis that the QF must make its commitment to the utility based on information known to it at the time the QF offers to sell its output ale is made is correct and consistent with PURPA. NWE's only arguments against it are an opposition to the idea that an LEO was created as of February 25, 2011, and an argument that Mr. Lauckhart failed to consider information that would have undermined his avoided cost analysis. As set forth above in Section B.2, supra, NWE is incorrect on the LEO issue, and Mr. Lauckhart did consider the information available to him, although he did not consider the Black & Veatch 2011 Spring report as it was not available to him as of February 25, 2011. Staff's legal analysis is consonant with PURPA and adds credence to Oak Tree's motion for reconsideration on the use of information available after February 25, 2011. To do otherwise would violate PURPA.

3. Staff's Position on Carbon Costs is Reasonable But the Probability Should be Adjusted by the Recent Federal Circuit Court Decision supporting EPA's Greenhouse Gas Regulations.

Staff supports Oak Tree's motion for reconsideration on carbon costs, stating:

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

Commission Staff's Answer to Oak Tree's Motion for Partial Reconsideration of Interim

Order at 6. Staff also notes that Oak Tree has provided the PUC with an analysis based on actual legislation. *Id.* However, Staff believes Oak Tree's estimate is unreasonably high given the probability of the legislation being adopted. *Id.* Therefore, Staff proposes to discount those prices by the probability of the legislation becoming law. *Id.*

First, Oak Tree commends the Staff for its thoughtful approach to this issue. However, Oak Tree would note that this sort of discounting has already been accomplished by several forecasting entities. NWE took into account the failure of Waxman-Markey to pass by discounting those costs in its 2011 DSP (based on the NWPCC's Sixth Plan from 2009), which NWE also used to justify the cost of Spion Kop. NWE took into account the failure of Waxman-Markey to pass by delaying the costs associated with cap and trade to later years of its forecast. Black & Veatch also discounted its November 2010 forecast by moving the costs associated with cap and trade legislation into later years.

In addition, the costs associated with current EPA regulations requiring construction and operating permits for greenhouse gas emissions are imminent. *See Coalition for Responsible Regulation, Inc. et al. v. EPA* , --- F.3d ----, 2012 WL 2381955 (D.C.Cir. June 26, 2012)(Exhibit 1, attached). The costs associated with EPA regulation of such gases can only be estimated at this point. However, it is quite likely that EPA regulation will not be less expensive than a cap and trade approach which seemed to have been favored by industry. Regardless, the point is that the probability of EPA regulation is now quite high, and at hearing, estimates of those potential costs should be considered. The probabilities associated with Congress acting to enact cap and trade legislation similar to Waxman-Markey to forestall EPA regulations should also be considered.

C. Conclusion

The hybrid methodology pays less than full avoided costs and discriminates against QFs in violation of PURPA. Avoided costs must be based on information known to the QF as of February 25, 2011. NWE's estimate of carbon costs is based on sketchy information and has no real evidentiary support. The PUC should reconsider these portions of its interim order of May 15, 2012.

Respectfully submitted this 9th day of July, 2012.

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing document was served electronically on this 9th day of July, 2012, upon the following:

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