

The Utility Preapproval Mess: Socialism Republican Style

By Roger Koopman

When Travis Kavulla and I were still serving on the PSC, we often made the point that protected utility monopolies like NorthWestern Energy were dedicated to "privatizing their profits by socializing their risks." Profit -- based on efficiency, performance and hard work -- is a very good thing, that incentivizes every competitive and free enterprise. But "profit" based on risk avoidance, protectionism and gaming the government system is the opposite of free market economics, and like socialism in general, rewards failure and punishes the consumer.

HB 99, currently before House Energy, Technology and Federal Relations Committee, would go a long way to fix the perverse, socialistic system of utility monopoly regulation that currently holds sway in Montana, by repealing a terrible, monopoly-coddling process that provides preapproval by the PSC of the generation assets NWE seeks to purchase. This aspect of utility regulation law literally turns incentive-based market economics on its head, and passes all the financial risk of a utility's bad decisions and over-payments onto the ratepayer. Worse, current law actually rewards utility monopolies like NorthWestern for knowingly paying too much for an asset, by providing approximately 10 percent net profits for every extra dollar of cost the PSC allows in preapproval. There is no going back.

Most utilities across the nation do exactly what any private enterprise is expected to do: make prudent, business-smart decisions on their acquisitions, based on an extensive process of analysis and due diligence. They then live with those decisions on a risk/reward basis. But not NorthWestern Energy! Before they buy anything, they are guaranteed that there will be no risk attached to their decision. The PSC's preapproval ensures that all bad outcomes will fall on the ratepayer, while the utility will continue to have its customers cover all costs plus 10 percent. So where is the incentive for NorthWestern to choose wisely and buy low? The answer: there is none.

Preapproval is an ancient relic from "deregulation" days, when Montana Power couldn't own power plants and was getting all its electricity from outside sources. It has no relevance to the post-deregulation energy marketplace, and yet NorthWestern's lobbyists have been able to successfully keep it in statute for 14 years since deregulation ended. The company has become weaker, not stronger, as a result of being artificially insulated from normal business risk. They continue to successfully socialize the risk through the power bills they send to all ratepayers, while reaping windfall profits on their bad decisions. Tragically, there are numerous examples of this.

The reason this anti-market, anti-consumer, socialistic statute remains on the books is not because the liberal Democrats embrace it, but because the purportedly conservative, free market Republicans do! Republicans just don't get it when it comes to market-based, incentive-based regulation of state-sponsored monopolies like NorthWestern Energy. For years now, GOP legislators have labored under serious misconceptions about utility regulation and the



fundamental difference between risk-overcoming competitive enterprises and risk-avoiding, protected monopolies.

I keep wondering when the light will go on, and these otherwise conservative Republicans will start reminding themselves of what they say they believe in, regarding freedom versus socialism. I keep hoping that in the "next session," Republicans will finally leap over the chasm they created between their free market beliefs and the way they swaddle NorthWestern Energy in a blanket of risk-shifting protectionism.

HB 99 is that opportunity for Republican legislators to take a stand for good, market based economics that not only serves and protects the interests of captive NWE consumers, but also prompts the utility itself to operate as a proud, confident and self-reliant enterprise, willing to assume its own business risks and become stronger and more efficient in the process. On the energy utility front, it's time to replace the lose-lose of socialism with the win-win of freedom.

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TESTIMONY OF ROGER KOOPMAN

House Bill 99

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MR. CHAIRMAN. In Montana, the history of public utility acquisition preapproval is a history of punishing the ratepayers. It is a relic from the days of Montana Power deregulation, applied to power purchase contracts, *not* physical assets, *and* has no relevance to current conditions or to a logical regulatory scheme. It should have been removed from code long ago. In the meantime, its application to the post-deregulation world of NorthWestern Energy has produced crony capitalist windfalls to the utility, and delivered higher rates to every NorthWestern customer.

The irony is that by shielding NorthWestern Energy from the normal market risks associated with the acquisition of major assets, it is arguably NorthWestern that is harmed the most. The requirement of making smart, prudent business decisions that benefit *both* the company and the ratepayer flies out the window – replaced by a system that can neither review nor respond to poor utility business decisions and overpriced purchases, and perversely *rewards* the utility monopoly for paying too much. The result: a weaker, softer company that focuses its primary attention on avoiding all risk. I'll give you two historical examples of rate inflation through preapproval in just a minute.

Among regulated public utilities in Montana, NorthWestern Energy enjoys the exclusive privilege of receiving PSC preapproval of major electric asset purchases. The advantage provided to NWE is enormous. While other public utilities are expected to shoulder the business risk of a new asset acquisition, and come before the Commission for evaluation of that asset at their next general rate case, NorthWestern's "preapproval" sheds that risk and places it squarely on the ratepayer's back. When NWE comes before the Commission with their rate case, it is with the knowledge that the asset has *already* received the PSC's risk-free seal of approval. Needless to say, NWE has much less incentive to perform the traditional due diligence of a corporate acquisition -- necessary to guarantee their purchases will be prudent and cost-effective -- when they are assured that the capital asset will receive full Commission compensation for O&M costs and return on equity, accomplished *before* the acquisition was made and before its prudence could be tested on the record. It's the perfect "no-risk win" for the utility and "all-risk lose" for the NWE customer.

There can be no logical justification for the special dispensation NorthWestern Energy receives. Because it occurs *before* the asset is in the utility's use, it does not allow for a proper vetting of that asset in the light of the utility's actual operation – including energy and capacity needs, asset costs and financial performance. If the purchase ends up being unwise, *the ratepayer bears all of the burden for the utility's mistake*. The benefit falls entirely on the monopoly utility, and the potential multi-million dollar losses entirely on the consumer.

Here's the preapproval history that I started to refer to earlier, involving two NorthWestern applications that were later shown to be based on wild overestimates of actual asset values. Had a traditional rate case approval been required instead, I'm convinced that NorthWestern would have established *much* lower price points and values. A rate case without preapproval would have no doubt disallowed a significant portion of the costs ratepayers were ultimately forced to pay. The first instance was the preapproval of the rate base for NorthWestern's 30 percent share of Colstrip Unit 4 in 2008. In this case, an asset that had an established net book value of \$37.5 million and an original acquisition cost of 187 million was given a rate base of \$407 million -- solely on the basis of NorthWestern possessing a purchase agreement for a similar amount from a company called Bicent. NWE doubtless had no intention of selling the thing. It simply wanted to squeeze as many dollars as it could from its customers, by skillfully using the preapproval option. And ratepayers are still paying through the nose to this day, not only from a rate base more than double what was justified, but also from potentially hundreds of millions in lost tax expense benefits.

The second instance of gold-plated preapproval was the hydroelectric dams purchase in 2014. As a relatively new commissioner, I myself got caught up in the enthusiasm for ownership of the hydros returning to a Montana utility, even while objecting to the bloated price tag. Preapproval was the only option before us, so I held my nose and voted for it. In a collateral statement attached to the Order, I expressed serious concerns that the dams were at least \$200 million over-priced. In hindsight, the figure was probably closer to \$300 million. The result of just these two preapprovals is an overpayment of \$300-400 million – placing a huge extra expense on ratepayers, while, with its 9.8% return on equity, producing for NWE a major boost in company profits. Under preapproval, the utility has the perverse incentive to spend *more*, not less for these newly acquired supply assets, and that's exactly what they did. While I don't have hard numbers available, I can assure you that these excess purchase prices, placed directly into rate base, continue to have a very significant impact on the electricity bills of every NorthWestern customer.

This legislation removes this special privilege NWE now enjoys, and places them on an even playing field with other Montana utilities and most utilities around the country. This not only protects NWE customers from asset purchases over which they have no control, but it also helps NorthWestern become a far better company in the long run, by having them accept full responsibility for the business decisions and capital expenditures they make. Preapproval not only unjustly burdens the utility consumer, but it works against the utility itself, by fostering weakness and risk-avoidance, rather than the strength and business wisdom a major private enterprise should exhibit.

For most jurisdictions around the country, the standard way for a public utility to acquire a major asset is to approach the question exactly the same way any other large corporation would: that is, by engaging in an extremely thorough due diligence process that assures that the acquisition is wise, prudent and correctly priced. Utility regulators understand that only by the company assuming the risk, can ratepayers be guaranteed of a fair deal – and fair rates. After the acquisition is completed and put into use, the utility then goes before the commission in a filed rate case, and seeks a fair return on the asset they now own.

This is also the way it is normally done in Montana – unless you are NorthWestern Energy. But in NorthWestern’s case, they have a special arrangement that allows them to go through a ***much***-shortened process, that provides the PSC with ***much*** more limited data, after which they can secure a “preapproval to buy” that relieves them of any further ratepayer responsibility for the acquisition. With preapproval, all the Commission is dealing with is a projection. A ***prediction***. NorthWestern brings in their hired experts who proceed to throw around their selective statistics, but they offer no hard evidence because there is no record of performance from which to draw. The acquisition hasn’t yet happened.

This stands in stark contrast to the traditional regulatory approach followed almost everywhere else, where the utility monopoly goes through an intense due diligence and negotiation process prior to acquiring the supply asset, integrates that asset into their company’s operation, and then comes before the regulatory commission in its next rate case, prepared to show from hard facts and extensive operational data, that the acquisition was economically prudent and thus, in the public interest. The Commission can then allow the full cost of the acquisition into rate base, or if the record evidence demands it, make adjustments that treat both the utility and the ratepayer fairly. Under traditional rate case vetting and approval, the utility says, “*Here are the facts. Judge for yourself.*” Under preapproval, the utility tells the Commission, “*This will be a prudent and cost-effective acquisition. Trust us.*” I would simply ask each committee member, as an energy consumer, under which system you would feel more protected and secure? Which system is more reliable and just? And which system provides the most incentive for the utility monopoly to get it right?

Not only does this preapproval process greatly diminish NorthWestern’s need to do a thorough and complete job in evaluating an asset’s economic value, and negotiating a fair price. It actually creates a strong counter-incentive to pay as much as they possibly can, because they will receive a roughly 10 percent return on the total capital cost! The ratepayer takes on all the risk for NorthWestern’s acquisition mistakes, and suffers mightily when NorthWestern frequently pays too much. The recent history of NorthWestern’s pre-approved acquisitions bears this out.

A final note, respectfully directed to members of my own party, under the general category of “remember who you are, and what you believe in.” Republicans are proud of saying that we believe in free markets. We believe that the rigors and the chastening effects of the

marketplace, under a system of risk and reward, brings out the best in private enterprise, which in turn, produces the best goods and services at the lowest prices. That is fundamental to our economic philosophy, and it is why we recoil at the notion of coddled companies and crony capitalism. Profit, based on investing wisely and overcoming risk, is the incentive that makes every company better and every consumer better served. Am I not right?

But curiously, something rather mysterious happens to our Republican philosophy when dealing with the regulation of natural monopolies like NorthWestern Energy. In the past at least, many in my own party have blurred the line between utility monopolies and competitive private enterprises that operate in a truly free and open market. We forget that we are looking at entirely different breeds of cat that require entirely different levels of regulation. Certainly, both seek profit. But while a competitive private enterprise is largely guided and regulated by competition itself, not so with monopolies that, by definition, have no competition. Their customers are captive and their markets are guaranteed. This is a *huge* difference.

My point is simply this. As Republicans, while recognizing the need for governmental rate regulation of non-competitive monopoly utilities, we must also strive to put in place those market-based incentives and connections to risk and reward that prompt those monopolies to provide the best possible service at the lowest possible cost -- and receive healthy profits based on their ability to deliver just that. Frankly, this is counter-intuitive to monopolies, as we will soon see from the upcoming testimony of NorthWestern. Pay close attention. While it is the nature of competitive enterprises to take on risk and overcome it, it is the nature of monopolies to avoid risk -- through politics and legislation -- and continue to enjoy their guaranteed existence. But hear me. **It doesn't work to shield monopolies from risk.** It is for us, as market-believing Republicans, to make a utility monopoly's profits more contingent upon performance, and less contingent upon avoidance and protection. That's the Republican way. And preapproval has been an enormous gateway to the avoidance of risk and to governmental protectionism at ratepayers' expense.

Members, it's very important that we understand what's been going on here. Preapproval is an antiquated and very bad idea, that ends up hurting everyone. This bill solves that problem, and begs your support. Your ratepayers will thank you. In the long run, NorthWestern may thank you, too.

Hello, Representative!

Thank you for listening to my (somewhat disjoint) testimony on HB 99 Tuesday. Would you indulge me in a few minutes of reflection?

The most revealing comments at the hearing came not from me or other proponents, but from the opponents – specifically, from NorthWestern’s David Hofman. His words (and histrionics) told the story far better than I ever could. Please consider:

1. First, he stated that “there was no risk shift” with preapproval. It just provided NorthWestern Energy with greater “safety.” Remember that.
2. Hofman then told us that purchasing generation assets without preapproval would make these actions *FAR TOO RISKY* for NorthWestern, and would force them to immediately stop any further acquisitions, and in the future buy all needed power from the market (as with deregulation.)
3. He then went further, asserting that without preapproval, NorthWestern runs the *RISK* of “investing a bunch of money that’s disallowed into rate base” (by the PSC) and that Montana would soon “have another bankrupt utility” on its hands.
4. Bottom line: Hofman was saying that NorthWestern was not willing to *ASSUME THE RISK* of buying new assets for their portfolio without the guaranteed protection of preapproval. No gas plants. No wind farms. No solar arrays. Nothing. *TOO RISKY FOR NWE.*

In saying these frightening things, Mr. Hofman just proved to the committee, exactly what the proponents had been saying about preapproval all along. He was acknowledging that preapproval *REMOVES FINANCIAL RISK FROM NORTHWESTERN, SO THEY CAN PROCEED TO BUY ASSETS WITHOUT THE WORRY OF THOSE ASSETS BEING PARTLY FOR FULLY DISQUALIFIED FROM RATE BASE AS IMPRUDENT OR OVER-PRICED.*

So we must ask, *WHERE DID THE FINANCIAL RISK GO, IF NORTHWESTERN WAS RELIEVED OF IT THROUGH PREAPPROVAL?* It didn’t just disappear. Vanish into thin air. Who picked up the financial risk that NorthWestern shed? There can be only one answer to that. *THE RATEPAYERS.* No risk shift? Of course there’s risk shift! It has to go somewhere. It can only land in one place – on the backs of the ratepayers every time.

In reality, the way this plays out is even worse. Protected by preapproval, NorthWestern has a powerful incentive to inflate acquisition costs – and rate bases – all the more, receiving a roughly 10% net profit on every extra dollar they can get through the Commission. By this process, NorthWestern not only sheds risk, it also increases the risk that is visited on the ratepayer. Perversely, that is how the game is played when a utility monopoly can wrap itself in the preapproval process. That is what happened with CU 4 in 2008, and it is what happened with the hydros in 2014.

Is it any wonder that NWE goes ten years or more between electricity general rate cases? Who needs an evidence-based rate case when you can get everything you want through preapprovals and trackers?

Three other points of clarification need to be made about things said at the hearing:

1. It’s a sham argument to draw a parallel between a PSC preapproval of a proposed new generation facility (which attempts to evaluate dozens of highly technical questions and

variables) and the preapproval of a car loan that only asks the question of financial ability to pay. Mortgage preapproval? Same thing.

2. The extended discussion about the thoroughness of a preapproval hearing, the ability to do discovery, etc., etc. is not at question here. It misses the point. The relevant question is this: *WHAT* is discoverable in a preapproval process and hearing? The answer is *NOTHING* that establishes or proves the prudence or acquisition cost accuracy of the asset itself. Why? Because in preapproval, that information is obviously not available. There is no data to discover because the asset is not owned by the utility yet. Preapproval is merely a series of predictions and optimistic forecasts, skillfully presented by NorthWestern's paid "experts", who enjoy a powerful advantage over the limited resources of intervenors and the MCC. That was the whole point, which may have been missed. An objective prudence analysis cannot be established in preapproval because, prior to ownership, there is simply no record to draw from.
3. The PSC is not opposed to this bill. They have for now taken a "monitor" (neutral) position on HB 99. Historically, the Commission has supported preapproval repeal -- including as recently as 2017, in a letter to ETIC laying out many of the same concerns about risk shift and reduced utility incentive to make good, cost-effective business decisions. The Commission stated, in part, its concerns that preapproval " (1) *insulates utility management from the consequences of bad decisions , which reduces incentives to analyze alternatives with the same rigor it would without preapproval, (2) regulatory commissions generally have less information and fewer resources available..., (3) shifts risks from utility managers/shareholders to utility customers who are not in a position to manage such risks, and (4) blurs the line between utility management and its regulators...*"

I hope this summary of yesterday's HB 99 hearing -- and the obvious conclusions that can be drawn -- will be helpful to you in your pending deliberations. Please feel free to call or email me any time, if there are additional questions you wish to discuss. Your support for this bill is vitally needed.

Thank you again for your time, and for your dedicated work in the public interest.

Respectfully,

Roger Koopman