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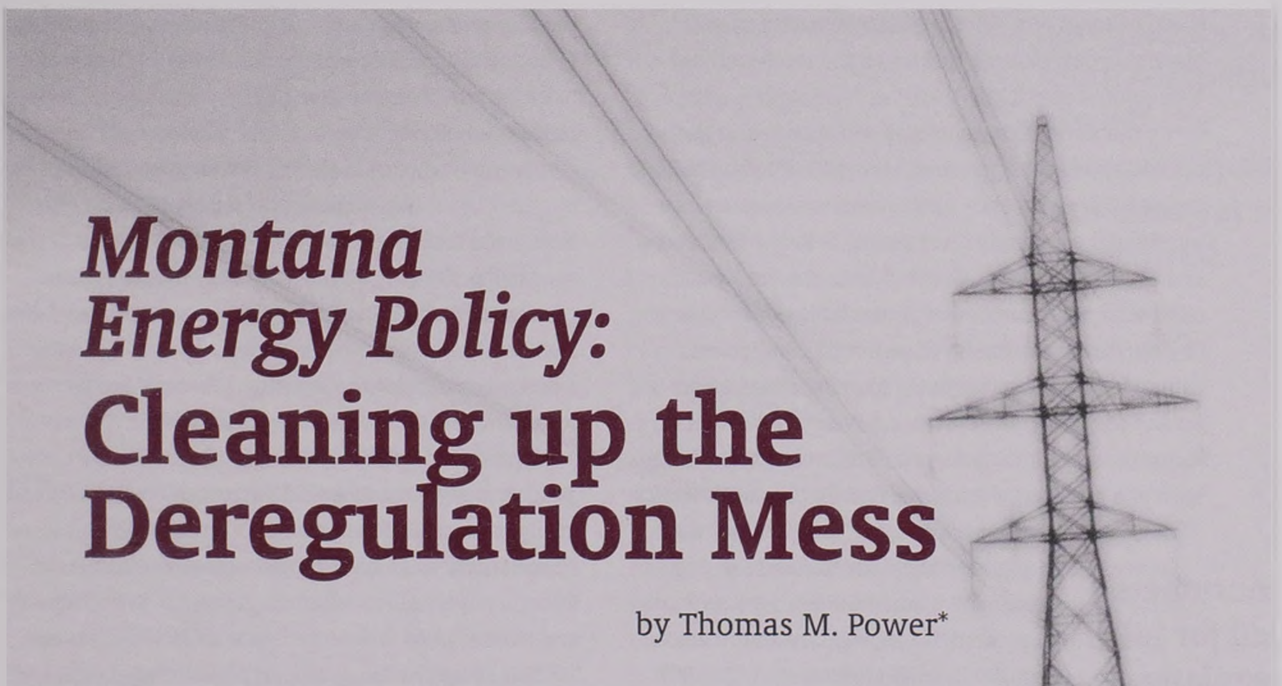

Montana Energy Policy: Cleaning up the Deregulation Mess

by Thomas M. Power*

In the early 1980s, Montana Power Company customers enjoyed, thanks to hydroelectric generation, some of the lowest energy prices in the nation. But this happy situation came to an end with two developments: the Montana Power Company (MPC) partnered with west coast utilities to build and operate the Colstrip coal-fired generating plants, and the energy economics picture changed unexpectedly both in Montana and nationally.

The lure of deregulation

The first economic blow was the Anaconda Copper Company, MPC's largest customer, shutting down its mining and smelting operations in the state. The utility's share of the new Colstrip plants became superfluous immediately, and the cost of coal-generated electricity increased. MPC's other large industrial customers began to turn to regional utilities for service, generate their own electricity, and substitute coal, fuel oil, and wood waste for natural gas. Then the Federal Energy Regulatory Commission (FERC), which regulates wholesale electric and natural gas transactions, moved to break up utility companies with local, protected markets and under-utilized plants. FERC planned to replace these individual, segmented utilities with fully utilized infrastructure, fully interconnected transmission lines, and regional wholesale energy markets. By the mid-1980s, MPC had little choice but to negotiate special lower rates in order to hold onto its large customers and to shift costs previously covered by the large customers to residences and small businesses. Approval of the Montana Public Service Commission (PSC) was needed, and MPC found itself in a series of bitterly fought and ultimately fruitless (from the utility's perspective) rate cases into the 1990s. With its revenue falling, MPC became increasingly less willing to invest capital in its utility operations and began to seek other, more profitable lines of business to pursue. In the mid-1980s, MPC spun off its unregulated businesses into a separate firm, Entech, which included its microwave and fiber optic cable system, coal mining, and oil and gas exploration. As the natural gas industry became more competitive and independent generation and cogeneration developed nationwide, MPC created the Independent Power Group to enter these free markets. MPC's business managers and business goals became tied more and more to these unregulated activities.

By the mid-1990s, wholesale competition in the electric and natural gas markets – mandated by FERC and the U.S. Congress – had become a wondrous reality. Amidst seemingly great supply, wholesale electric and natural gas prices declined both absolutely and relative to what customers of regulated utilities were paying. Large customers of regulated companies demanded that they be given access to these plentiful and cheap supplies. One response was to treat major users as wholesale, not retail, customers, but in Montana big energy consumers made the political decision to seek "choice" for all rather than special treatment for themselves. Big consumers pushed for full retail deregulation, competition, and customer choice, and that is what Montana got. In 1997 the Montana Legislature enacted and the governor approved full electric and natural gas retail competition. MPC went along, ambivalent about its future in the regulated utility business and assured that its past investments in electric and natural gas supply would be protected.

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The disappointment of deregulation

Under deregulation, Montana's big utility customers could chose their energy suppliers in 1998 and other customers were scheduled to do so by mid-2002. All customers began to pay a "competitive transition charge" so MPC could offset its declining worth due to deregulation. But because the energy market was looking increasingly volatile, MPC in 1998 sold its electric generating plants to Pennsylvania Power and Light (known in the state as PPL Montana) and emerged from the sale as an electric distribution company only. The electricity MPC was to distribute now had to be obtained from an unpredictable wholesale market, and the deregulation legislation imposed a multi-year freeze on what MPC could charge its retail customers. With the distribution business also looking risky, MPC decided in 2000 to get out of the utility business altogether and sell its remaining utility assets to NorthWestern, a South Dakota-based company. MPC then put the proceeds of the sale and its remaining energy assets into Touch America, its telecommunications subsidiary.

PPL Montana (PPL) and NorthWestern remained on the Montana energy stage, accompanied by Montana-Dakota Utilities and rural cooperatives that had lobbied to be exempt from the deregulation legislation. No significant wholesale suppliers ever materialized. Reliable competitive wholesale electric markets had not yet matured in the West, and it was simply too costly to have several producers chasing small consumers across geographically vast Montana. Ironically, given the promise of deregulation, electricity prices skyrocketed from less than a penny per kilowatt-hour to as high as a dollar per kilowatt-hour just as Montana looked to those markets for low prices. Small electricity users were protected by the temporary rate freeze, but – another irony – the large industrial customers who had brought deregulation to Montana got hurt the most. As electricity costs rose, copper mining operations in Butte, a paper mill in Missoula, refineries in Billings, and lumber mills around the state shut down. As the 2002 deadline for full retail competition approached, Montanans were in no mood to continue the deregulation experiment.

Failing to put Humpty together again

The PSC and Montana Legislature have slowly shed their hopes for vigorous energy competition. NorthWestern Energy, just a "pipes-and-wires" company delivering electricity and natural gas it has purchased from suppliers, has become the permanent distributor to the former MPC's residential and small commercial customers. Larger customers have had to make a one-time, permanent choice as to whether they want NorthWestern to provide them with energy or whether they will go into the market and obtain it themselves.

Tentative steps have been taken to "reintegrate" NorthWestern, which means allowing it to own generating as well as distributing resources. NorthWestern owns no generating plants today, but Montana law now authorizes the company to build or buy generating plants and charge customers for their ownership and operating costs. Northwestern is currently considering this option in order to supplement its existing short-term and intermediate-term contracts. NorthWestern has also, under legal mandate, embarked on energy-supply planning that includes not only energy sources and costs but also environmental, climate, and efficiency considerations. This broad planning focus returns NorthWestern to the process MPC was using between 1988 and 1996.

But all this effort at reintegration and re-regulation has not "put Humpty together again." Montana's failed experiment in deregulation and retail competition has left the state with many problems yet to be resolved.

Montana's energy agenda

What are these problems, and do good solutions exist? The first problem is Montana's loss of a state-based utility. NorthWestern remains a Sioux Falls, South Dakota, utility, even though about 80 percent of its business takes place in Montana. Some bad results of absentee ownership and management have been conflict and delay in energy supply decisions, political insensitivity, and duplicative staffing. A wave of utility mergers is currently and optimistically occurring around the country, but being swallowed up by an out-of-state corporation has brought Montana no measurable gains.

The second problem is the absence of business-like incentives for NorthWestern. The utility spends hundreds of millions of dollars purchasing electricity and natural gas for its customers, but the PSC denies recovery of millions of dollars of supply costs because it questions NorthWestern's prudence. The utility earns a profit on its investment in transmission and distribution lines and pipes, but not on energy purchases and sales. On orders from the legislature and PSC, NorthWestern is, in effect, running a $300 million not-for-profit operation for its customers. This makes no business sense. NorthWestern should be making long-term supply decisions and building a balanced energy portfolio but, instead, it is transferring risk from itself to its customers by buying energy on the spot market.

The third problem is dependence on a single unregulated electric supplier, PPL Montana. When MPC sold its generating facilities to a single unregulated wholesale supplier, Montana energy consumers exchanged a publicly regulated monopoly for an unregulated monopoly. PPL Montana and FERC argue that competition from other suppliers has tempered PPL Montana's monopoly power, but the PSC and NorthWestern insist it has not. What's clear is that the unregulated PPL Montana remains the state's dominant electric supplier, which is not a good deal for Montanans.

The fourth problem is that it isn't clear who will pay for the new transmission lines that are needed for a better Montana energy future. Wind and coal developers have been frustrated because the existing transmission system limits the export of electricity. Not knowing whether they will be able to get their product to market, they have been hesitant to expand production. In the past, regulated utilities built transmission lines because their customers were served by the new facilities and companies could recoup their costs. But it's not clear why NorthWestern's customers should be forced to pay for transmission-line upgrades that would facilitate another company's export of electricity. The unanswered question of "who should pay?" has stalled construction of new transmission and generation facilities.

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The fifth problem is the importance and intractability of environmental issues, including possible global warming. Montana has world-class coal supplies that the coal industry and some officials want to develop to meet the nation's energy needs and spur economic development in eastern Montana. Coal-fired electric generation, however, poses many public policy issues because it involves extensive strip mining and produces greenhouse gas emissions and acid rain. Who should decide these environmental and economic issues? NorthWestern, as a private business, can argue that it should not be making policy – balancing profits and public health, cost recovery and conservation – or be left to guess what future policies might be. The PSC could get involved, except for the fact that high energy costs are one of the strongest incentives to conserve energy and the regulatory body is charged with keeping energy prices as low as possible. Among the casualties of deregulation were the Montana's Major Facility Siting Act and the state's Energy Planning Division, which had provided a governmental framework for working through such difficult issues.

The public power alternative

Amidst the turmoil of deregulation and the bankruptcies of Touch America and NorthWestern, several attempts have been made to replace the state's investor-owned utilities with a publicly-owned utility. The most recent proposal came from a coalition of the

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state's largest cities. It aims to shut the door on the era of PSC-regulated private utilities. The core mission of a publicly-owned electric and natural gas utility would be to resolve in a public manner the important public-policy issues just discussed. So far sufficient support among energy activists, environmentalists, and the wide range of energy consumers has failed to materialize. Many are too familiar with publicly-owned utilities that have not operated democratically and neglected consumer and environmental interests. Many have been unwilling to assume that a "public" utility would be any better than government regulation of a privately-owned utility. Such a promising chapter in Montana's long and colorful history of energy politics will have to be prefaced by more vigorous and responsible public dialogue.

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