Playing the power game: The story of energy deregulation in Montana

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Playing the Power Game:
The Story of Energy Deregulation in Montana

by
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B.A. Grinnell College, Iowa. 1993
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This series of stories examined why Montana’s legislators and business leaders embarked down the road of electricity deregulation back in 1997, and in the aftermath of skyrocketing electricity prices across the West, whether or not they still support that decision.

The series finds that Montana’s Republican leaders and many of its business leaders still support deregulation, despite high prices, job losses, and being subsumed into a larger Western regional market outside of their control.

So far, deregulation is set to cost Montanans hundreds of millions of dollars a year in increased power bills. The results will be felt for years to come in the state’s already faltering economy.

In 1996 the wholesale electricity market looked healthy, with plenty of supply and competition. But it was a mirage that quickly dissipated, revealing a supply shortage and utilities unwilling to build new power plants. Policy errors in California and Montana only made the situation worse.

In contrast, Pennsylvania has been successful in two areas: aggressively managing competition and lowering prices. Montana has a lot to learn from its example.

Montana’s large industrial companies have been hit particularly hard, with mines, lumber mills, and aluminum plants closing down. These companies were the first to enter the new and unfamiliar deregulated market and the first to get burned.

Montana’s electricity market is still in its infancy. So far things have not gone as planned. Only time will tell if the new generation plants planned in the next few years will increase competition and lower prices.
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Chapter One

Welcome to the Free Market

Montana struggles through its power market transition

It is estimated that Montana will pay an extra $182 million a year for electricity starting in the summer of 2002.

That represents $200 a year out of the pocket of every man, woman and child in the state of Montana. Most of that money will end up in the pockets of out-of-state power generators.

The average Montana home, using 750 kilowatts of electricity, will see its monthly bill rise from around $60 a month to about $85 a month.

The increase in electricity generation rates, from 2.6 cents a kilowatt-hour to an estimated 6 cents a kilowatt-hour in July 2002, means Montana Power Co.'s customers bills will approach $492 million, up from the $310 million consumers now pay, according to the state's own estimates.

The days of regulation and controlled power prices are gone.

Montana has entered the deregulated or free market, where power prices are based on what consumers are willing to pay. And right now, with a power shortage across the West, consumers are paying a lot more to keep their factories, computers, televisions, and air conditioners running.

Experts say market prices, now more than 10 cents a kilowatt-hour, will settle under 5 cents a kilowatt-hour in two to five years. If true, the five-year contract Montana Power
Co. is set to sign with PPL Montana for electricity at 4 cents a kilowatt-hour to provide part of the power needed in Montana looks pretty good. The rest of the electricity will have to be purchased on the market, raising the cost for Montanans to about 6 cents a kilowatt-hour.

The Montana Power/PPL Montana contract was hammered out between the companies on the last day of the Legislative session after repeated threats from the Montana Legislature. The Legislature demanded affordable power for Montana customers and used huge profit taxes and reregulation legislation as tools to get it.

Gov. Judy Martz and Republican leaders say the Montana Power/PPL Montana contract is the best deal Montana could get.

Senate Majority Leader Fred Thomas, R-Stevensville, said that prices would have gone up to more than 3.5 cents a kilowatt-hour anyway if prices hadn't been frozen at 2.25 cents a kilowatt-hour in 1997 as part of the original deregulation legislation. He also said he expects Montana electricity prices to eventually settle in the 4 cents a kilowatt-hour range.

"That's where prices would have risen to now under normal circumstances anyway," he said.

Thomas may not be far off.

According to Michael Zenker, an expert on the West's electricity market for Cambridge Energy Research Associates, Montana's electricity generation costs will eventually settle in the 4 or 5 cents a kilowatt-hour range after peaking later this year at 65 cents a kilowatt-hour. But that 4-cent power is still years away.
John Hines, an economist with the Northwest Power Planning Council, said all the estimates he has seen show that prices will remain high until 2004 or 2005, when enough new generation plants are built to meet demand.

In the intervening years, Montana's economy will be hit hard.

Paul Polzin, director of the Montana Bureau of Business and Economic Research, said the higher energy cost are forecast to reduce Montana's economic growth from 2 percent to about 1 percent, which means fewer new jobs and smaller raises for those with jobs.

Help may be coming sooner rather than later in the form of two new generation plants being built in the next couple years.

Hines believes the new generation facilities will go a long way in creating competition and helping to keep power prices in Montana lower than the high market rates seen in the rest of the West.

"The proposed new generation facilities will significantly change the market for the better in Montana," he said.

Continental Energy Services is planning a 500-megawatt natural gas generation plant near Butte by July 2002. North Western Corp. is building a 240-megawatt natural gas generation plant with production of 80-megawatts this fall, and the remaining generation running by the end of 2002.

Both projects will benefit from the tax incentives and changes in environmental laws aimed at encouraging new electricity generation plants in Montana. The Legislature passed the laws hoping to increase competition and lower prices.
It is estimated that both natural gas plants being built will be able to sell electricity close to the cost of production for about 4.5 cents a kilowatt-hour. That's about where experts believe the price will settle.

Some say that the Montana Power/PPL Montana contract is a raw deal, that the state could have imposed price controls or reregulated.

Don Judge, head of the Montana AFL-CIO, doesn't believe the Montana Power/PPL Montana contract is a good deal, and he faults the Legislature. He says the Legislature didn't do anything to improve the power situation in Montana or to help ordinary Montana citizens.

"The Republican majority, in cooperation with the governor, failed to grasp the issue and give it leadership to help Montana's citizens," said Don Judge, head of the Montana AFL-CIO. "Instead, they rolled over to PPL Montana and Montana Power in a way that will cost Montana hundreds of millions of dollars and give these companies large profits."

The Republican leadership disagrees.

The Republicans are staying with the free market and said it offers the best long-term solution. They said they have stabilized electricity generation rates for Montana residential customers, and have taken steps to encourage new power supply in the state. Although prices in 2002 will be initially higher than their 4 cents a kilowatt-hour goal, they expect prices to come down as supply increases.

To ease the transition to the free market, the Legislature passed a few measures to help low-income households and to give some industrial customers a year reprieve from the high wholesale market prices.
A handful of low-income residential customers will be helped by the extension of the Universal Service Benefits Charge program, an additional charge on power bills, which helps to fund a 15 percent discount in the power bills of poor Montanans. The money also supports a free weatherization program for income-qualified customers, and emergency help with power bills.

Industrial customers will get some help from a power pool of about 170 megawatts created through conservation and donations from power generators. Administered by the Public Service Commission, the power pool will offer some industrial customers low-cost power, generally around 3.5 cents a kilowatt-hour to 4 cents a kilowatt-hour. But the power pool only provides up to 50 percent of any one company's power needs and won't come close to providing the 800 megawatts of electricity that Montana industry uses.

Another option for the smaller industrial customers in the free market using more than one megawatt of electricity is to come back to Montana Power Co.'s service starting July 1. But that won't help them much. Many of these companies are struggling with power prices in the 5 cents a kilowatt-hour range. And if they come back to Montana Power they'll pay the same 6 cents a kilowatt-hour after July 2002 that residential customers will pay.

The power pool and industrial customers return to Montana Power's service is only a partial solution to the state's power needs, as is the deal Montana Power and PPL Montana have agreed to.
The Montana Power/PPL Montana deal would provide only 500 megawatts of Montana Power Co.'s average load of 750 megawatts to 1100 megawatts. The remainder would have to come from the expensive wholesale market.

Montana’s consumers don’t know what to think, and many admit they don’t understand deregulation.

Monica Adkins, a Missoula businesswoman, said she heard that Montana Power estimated that the average customer’s electricity bill would go up about $300 a year, but she isn’t sure what the Montana Power/PPL Montana deal was all about.

“I think $300 is a lot of money,” she said. “But I’m not sure what anyone can do about it.”

Other consumers see it as inevitable that they will take it on the chin while Montana Power and PPL Montana, the company Montana Power sold its generation plants to, turn significant profits.

Ryan Price, said he isn’t surprised that taxes or price controls weren’t imposed on Montana Power Co. or PPL Montana. He said these companies know more about the issue and can more easily influence the legislative outcome.

“These guys are already ahead of the curve,” he said. “They’re out ahead of consumers on energy issues, so they have the advantage.”

Republican leaders defend the Montana Power/PPL Montana contract as a good free-market deal for Montana. Without it, they said, residential power costs would likely climb even higher next summer.

Montana’s industry is hoping for lower market prices sooner rather than later.
Ralph Denoski, manager of a cement plant near Bozeman, said the Legislature didn’t do much to help his company. But he thinks a free power market is a good thing and that it will eventually bring lower prices. But, in the meantime, he’s not sure what he’s going to do.

While some of Montana’s industrial companies are struggling, Montana’s electrical utilities and generators are doing just fine.

PPL Montana’s parent company, Pennsylvania-based PPL Corp. reported record 2000 annual earnings that were 40 percent higher than the previous year, and a 54 percent increase in income in the first three months of this year.

Industrial and residential consumers need affordable power, and power companies need incentives to build new generation plants to meet growing demand.

Montana’s newly opened energy market is struggling to find that middle ground.

“Energy prices are always a mixed bag,” Polzin said. “High prices help producers, but can hurt consumers. Low prices help consumers, but can hurt producers.”
Chapter Two

For Some, Mirage of Cheap Power Turns into a Nightmare

A once avid supporter of energy deregulation changes his mind

It's much quieter these days around the offices of Greg Stricker's open-pit copper-mining company in Butte, with only a few employees and his frustration to keep him company.

Most of his 320 employees were laid off last July. Some of them are friends and others he's known for years. He let another 10 go a couple of weeks ago.

Only 13 employees remain with what had once been one of Montana's major industrial employers. The mine is at a standstill.

The price of copper, regulations, labor disputes, and the usual industrial concerns had nothing to do with it. The mining stopped because Stricker couldn't afford the electricity.

He's angry he didn't consider the negative impacts deregulation might bring, and he's frustrated that he and state lawmakers jumped on the deregulation bandwagon in 1997 without studying the issue more thoroughly.

"Closing the plant was devastating," he says. "Everyone around here always tracked the price of copper. It was a shock to our managers and workers that electricity was such a volatile issue."

Stricker and his company were among many that initially pushed for electricity deregulation in Montana, mainly because wholesale prices were cheaper than the regulated
rates at the time. Now Stricker says he made a mistake. He says that he and others failed to realize the value of cheap electricity provided by Montana's hydropower and coal generation facilities and failed to understand how vulnerable Montana is to swings in the larger Western electricity market.

In the short run deregulation was a way for Stricker's company and other large Montana industries to increase their profits. In the long run it looked as if Montana would have a competitive electricity market because large marketers like Enron Corp., and regional utilities like Avista Corp., were roaming the halls of the state capitol building and asking to participate in an open electricity market in Montana.

To their dismay, Stricker and other deregulation supporters discovered that the low wholesale market prices were a mirage. But unlike Stricker, most industrial customers still support deregulation.

"My biggest frustration is that we embarked down the deregulation path to begin with," Stricker says. "We didn't fully realize the importance of Montana's cheap generation assets to Montana."

It was a leap of faith gone wrong.

Tom Power, an economics professor at the University of Montana and an active participant in the deregulation debate from the beginning, says the move toward deregulation was driven by a philosophy that free markets are good and government control is cumbersome and wasteful. Deregulation supporters assumed that the low prices, around 2 cents a kilowatt-hour, were natural and here to stay.
That assumption wasn't true. As wholesale prices rose because of a supply shortage in California and the Northwest, the mirage dissipated and the whole thing fell apart.

"They felt that regulated prices were an anti-market government bureaucrats' construct," Power said. "That if you get rid of the bureaucrats' prices would go down to some natural level that was lower than the current one. It was just faith that that was the case."

Supporters argued that open markets and competition go hand in hand. So they opened up the electricity market and waited for competition to follow.

"Competition inside Montana was not central to what the legislators were doing," said Power. "They thought of it as more of a philosophical issue."

Without any support or guidance, competition never developed.

As excess power supplies dwindled and wholesale prices rose across the West, the out-of-state generators and marketers so eager to compete for Montana customers disappeared.

"There appeared to be enough competitors," says Power. "Nobody (the generators or marketers) had to put any dollars on the line, all they had to do was fill out a form to be a licensed provider. There were all these utility executives at these meetings so it was easy to maintain the fantasy that there were all these competitors."

Power also pointed out that most other states that moved toward deregulation, including Pennsylvania -- touted as the most successful -- had competitors in place.

"Here you didn't have competitors in place," he says. "And as a result, it turned out there aren't any competitors."
The mirage of competition and lower prices that Montana’s deregulators saw in 1997 was in fact a temporary bulge in power generation caused by the federal governments opening of the wholesale market a year earlier.

To deregulation supporters, the low prices initially seen in the newly deregulated wholesale market were proof that deregulation brought cheaper electricity to both industrial and residential customers.

But the excess supply they saw was an illusion. Utilities had no incentive to build new power plants to increase supply. The low wholesale prices didn’t cover the cost of building new power plants, and utilities no longer had guaranteed and regulated customers to pay the bills.

The mirage of excess power came about during the transition to the new federal rules.

Before 1996, federal regulations allowed utilities to recover the costs of maintaining 15 percent more generation capacity than their expected peak to safeguard against uncertainties and contingencies. As a result, Montana and other states had a built-in excess supply. Some generation plants were kept idle at times of low demand because other utilities would let competitors sell to its customers. But after the federal government deregulated the wholesale market, regulated and non-regulated utilities suddenly kept all of their power plants burning to make extra cash by selling that excess power on the wholesale market.

"There was more supply out there than previously appeared to be because utilities operated all of their plants and competed with each other on the wholesale market and drove the price down," Power says.
With every power plant in the West fired up to sell all of its capacity on the wholesale electricity market, prices dropped.

Seeing the low prices, Montana's industrial customers pushed for deregulation, or "customer choice" as it was called, and asked themselves why they should belong to a regulated market where they pay for the cost of building and running Montana Power's Colstrip generation facilities when they could get cheaper power on the wholesale market.

"How long did the industrial customers think that the excess supply was going to last?" Power asks. "It's a one-time only thing. If you put it in an economic context, if prices are being driven down to operating costs then who is going to build new generation?"

Power says industrial customers saw a surplus and wanted to quickly take advantage of it. Of course, the low prices depended on too many favorable variables, like low natural gas prices and high-water levels behind the regions hydroelectric dams.

It couldn't last.

Stricker knows that now.

"We didn't foresee the high prices and all of the problems," he said. "We really didn't have any idea that the West would be so supply constrained. And we didn't understand the role of other states in affecting the price of electricity in Montana."

Generators and marketers didn't foresee the problems and the price spikes either.

Stricker says that through April 2000 he was getting one-year and two-year contract offers in the upper $20 a megawatt-hour range. In May prices doubled to $50 a megawatt-hour, and doubled again in June to about $100. He said if the generators and marketers
had known prices would jump in May and June they wouldn't have offered the contracts
they did in April.

Now that Montana is well down the road to a deregulated market it's unlikely they will
see electricity prices as low as $25 a megawatt-hour again. Both Senate Majority Leader
Fred Thomas, R-Stevensville and Sen. Mike Taylor, R-Proctor, a member of the Senate
Energy and Telecommunications Committee, said they hope to eventually see electricity
rates around $40 a megawatt-hour.

The price will likely stay above $25 a megawatt-hour because most new electrical
generation plants either planned or built in the last few years are run by natural gas
turbines. These turbines can be bought off the shelf, making it easy to build, and clean-
burning natural gas makes it relatively easy to meet environmental regulations.

With gas prices where they are right now, moving up from around $2 a thousand cubic
feet a couple of years ago to more than $4 a thousand cubic feet today, Continental Energy
says that it will be able to sell electricity from the 500 megawatt plant it's planning near
Butte for about $45 megawatt-hour.

But in 1997 it was assumed that electricity in the $25 a megawatt-hour range was
normal and large increases were unfathomable.

Strieker hopes the price comes down, but he's not sure it will fall far enough.

If Stricker's mining operation is ever to reopen, let alone survive, he says copper prices
will have to rise and the mine will have to find a way to conserve energy to offset the
higher costs of electricity. Right now he needs a price around $35 a megawatt-hour to be
profitable.
"In a world where new generation costs more than the old regulated rates it's going to be difficult," Strieker said. "It raises the bar for us as we try to survive."

Opponents of deregulation argued all along that business leaders and the Republican-controlled Legislature were so blinded by the glory of the free market that they didn't stop to study Montana's energy needs or how the state might be affected as a small player in the wholesale electricity market.

"There was no rigorous analysis and no intellectual honesty," said Senate Minority Leader Steve Doherty, D-Great Falls, an early opponent of deregulation. "It was: 'Hey, we think (deregulation) will work, and competition is good and it will lower prices.' That was it. And if you said that 10 times you were a true believer. It was a really bad leap of faith."

Doherty says that arrogance and short-sightedness continue. In the 2001 legislative session, Rep. Kim Gillan, D-Billings, sponsored a bill to develop a state electricity policy and plan, but it was killed in the House Appropriations Committee.

"We don't want to think about what we're doing," Doherty says sarcastically. "We just want to react."

Republican leaders acknowledge that all is not well, but argue that Montana wouldn't be in this mess if Montana Power Co. hadn't sold its generation and transmission assets, even though the Public Service Commission approved it and the deregulation legislation allowed Montana Power to retain the proceeds. They say Montana Power customers would have seen price increases, but not the jump in prices residential customers can expect after June 2002.
"The big key thing was that MPC made the decision to sell its generation facilities in 1998," says Thomas. "That is a significant change from what the legislation contemplated. If they would not have sold them then they would still be regulated through the transition period."

Legislators all thought that out-of-state firms would compete with Montana Power, not that Montana Power would sell to an out-of-state firm.

Strieker agrees with that viewpoint. Once Montana Power sold its low-cost hydropower and coal generating assets to the out-of-state firm PPL Montana, the obligation to sell to Montana customers went with it, he says.

"PPL Montana believes that it has no obligation to serve those large industrial customers that left MPC, and beginning in July 2002, PPL believes that it has no obligation to serve any Montana customer," Strieker wrote in a letter sent to all legislators and Gov. Judy Martz. "With the sale (to PPL Montana) Montana suddenly lost its competitive advantage."

Still, supporters of deregulation are holding fast to the belief that deregulation is not the problem. They believe that the market will work itself out and provide low-cost electricity down the road.

"The fact is that states like Idaho, which have not deregulated, are experiencing the exact same problems," says Shane Hedges, chief policy advisor for Gov. Judy Martz. "Montana has a different dynamic than other states because it has deregulated, but the problem is supply in the Western grid."
Doherty agrees that prices would have gone up under a regulated system as they have in other Northwestern states. But, he says, the magnitude of problems Montana is facing today would be less severe.

"Yes, prices have gone up in regulated markets, but not as much as in unregulated markets," Doherty says. "This notion that it would have happened anyway is an attempt at political cover for bad decisions and to justify the continued slavish adherence to an ideology."

Stricker says the best hope to get his mining operation running soon rests with the PSC's ability to control prices.

In March, the PSC said that it hadn't yet finalized deregulation and could still control electricity prices. But proposed legislation to strengthen the PSC's position didn't pass. Now the PSC isn't certain it will pursue price controls without the Legislature's support and an almost certain lawsuit by Montana Power Co. and electricity generator PPL Montana.

However, Republican leaders are certain deregulation will work.

"Clearly there were some things that could have been better thought out in the 1997 legislation," Hedges says. "But we're not going backwards. Because of deregulation we now have unprecedented opportunities in the state of Montana to encourage competition and increase the amount of supply."

Detractors respond with exasperation. They say electricity is not a true commodity and market forces will only lead to monopolies and high prices for consumers.
"I think energy deregulation is probably one of the biggest scams ever perpetrated on
the country," Doherty says. "There's a reason why we regulated electricity. It's a
commodity unlike other commodities. It's necessary for modern living.

"I think it's going to rank with the savings and loan scandal with what it's effects will
be," he says.

For Stricker, the glory of an open electricity market has faded. He asked for
reregulation in the last legislative session. Looking back, he says the goals in 1997 weren't
realistic. Montana had the fifth lowest electricity costs in the country. It should have been
obvious that lower costs would be difficult to come by.

"We should have seen that we couldn't get lower prices on the wholesale market,"
Stricker says.
Chapter Three

Rational Decisions in an Irrational Energy Market

Montana industry gets burned in a market it helped to create

Dick Johnson first heard of the Mid-Columbia Index, a wholesale electricity market index for the Northwest in 1997, around the time Montana passed its deregulation law.

Now he knows it all too well. One of the first things Johnson does at work in the morning is go online to check the price of electricity on the index. As manager of Ash Grove Cement near Helena, Johnson knows that every day the wholesale price remains in the $200-a-megawatt range is another day that his company loses money and the closer it comes to shutting down.

The Mid-Columbia Index is important because it determines, for the most part, the cost of electricity contracts for Montana companies. And those costs are sky high.

Industrial companies like Smurfit-Stone Corp., Golden Sunlight Mine, Conoco and Ash Grove Cement buy commodities like wood, metals, and oil in their everyday business. They’re used to commodity price swings, but they’ve never seen anything like the price swing in energy. Most are paying three or four times more for electricity than a year ago. Some have cut-back production or closed down. More are in danger of doing so in the coming months.

These companies, the most prepared and sophisticated electricity customers in Montana, were caught off guard by a number of factors, including low water levels in
the regions dams, a surge of demand in California, and a lack of new generation facilities - all of which converged to drive up wholesale electricity prices to astronomical heights.

The smaller companies are the most passionate and outspoken about the high cost of electricity because it hits their bottom line the hardest. Johnson said electricity is one of his company's three biggest expenses, but it has leaped to the top since the rise in wholesale prices.

"We're being held with a gun to our heads," said Johnson. "We have to buy power to operate. But you're not getting any more for a price that's 10 to 15 times what you were paying a year ago."

And what they have now was hard to come by.

Johnson said Ash Grove Cement signed an 18-month contract with Enron Corp. in December 1998 for electricity at $23 a megawatt-hour. It was the longest contract he could get at the time. He said companies using 25 megawatts or more of electricity were offered contracts with longer terms. But Ash Grove uses only six megawatts.

In June of last year, Johnson signed a five-month contract with Enron at $79 megawatt hour as wholesale prices started to take off. He thought the price would drop after that five-month contract when peak summer demand diminished.

He was wrong.

Instead, wholesale electricity prices rose again in October. One to two year contracts were quoted around $200 a megawatt-hour and a five-year contract at $100 a megawatt-hour.
He was stuck. He couldn’t afford the market prices and he couldn’t get back into the regulated market.

Once a company stepped out of the cozy regulated market the doors locked behind them. A tariff plan adopted in 1998 by the Public Service Commission kept them from returning.

The high-price contracts on offer could drive Ash Grove out of business. So, as a stopgap measure, the company has rented diesel generators that cost about $140 a megawatt-hour to operate while it waits for prices to drop.

Other companies tell similar stories.

Don Quander, an attorney representing 11 large industrial companies, said his clients, most of whom are in the oil, mining, and timber business, expected swings of only 15 percent in the price of electricity.

"The notion of a 1,000 percent swing was unimaginable," Quander said.

Electricity in the $50 a megawatt-hour range is the most these companies can afford, he said. If it’s not available, Montana will see more production cut-backs, layoffs, and closed businesses.

Initially, the choice was simple. Deregulation saved money.

In 1998, Bob Boschee, general manager at the Smurfit-Stone plant in Frenchtown, said his company had two choices: it could pay about $28 a megawatt-hour in regulated generation rates, higher than the average $24 a megawatt-hour residential customers paid, or it could immediately save money in the deregulated market.
"We opted for deregulation because we were subsidizing the retail customers in the regulated market," he said.

That first contract for Smurfit-Stone in the deregulated market initially cost under $25 a megawatt-hour. It was a two-year index contract, one where the price varies with the ups and downs of the wholesale market. It provided 25 megawatts of the 60 megawatts of electricity the plant used. He said the index contract made sense at the time because he expected prices to go down further. Instead, the company found itself signing a contract for twice that amount last fall.

Others are waiting for the hammer to fall.

The Golden Sunlight Mine near Whitehall, operated by Placer Dome of Nevada, initially signed a longer term contract than Smurfit-Stone. Rory Tibbals, operations superintendent at the mine, said his firm's contract with PPL Montana runs through the end of June and costs them $29 a megawatt-hour.

Golden Sunlight has been offered a small reprieve. Starting in July, the Public Service Commission will be administering a power pool to help Montana industry. Golden Sunlight is working on a deal to get 10 megawatts from the pool at a cost of $35 a megawatt-hour. But that's only a short-term solution and relies on donations from generators and conservation efforts.

The question is what to do after that. Golden Sunlight's room for maneuver is small. Tibbals said if the mine can't sign a contract under $40 a megawatt-hour it will be unprofitable and will have to close. And with an estimated 15 months of
production left after July, the longer it takes to get a contract it can afford the less likely it will reopen, he added.

"The kind of quotes we're getting off the (wholesale electricity) market are death to us," Tibbals said.

Even the large and sophisticated international oil companies, like Conoco and ExxonMobil, were surprised by high electricity prices.

John Bennitt, director of public affairs at Conoco Inc., which has a refinery in Billings, said the company supported deregulation and still does. He said his company is renting 19 one-megawatt diesel generators to power the Billings refinery and pays 20 times more a day for electricity than a couple of years ago. It plans to ride out the market storm and sign contracts when prices come down, he said.

Not one of Montana's industrial companies expected the free market in electricity to lead to astronomically high prices, and most think the situation is an anomaly. They believe the shortages in California and the drought keeping output from dams in the Northwest at low levels will subside and new suppliers will be found.

"It's a $20 commodity," said Boschee, referring to the cost of electricity production at Montana's Colstrip power generators. "At $40, that's a 100 percent profit. In a free market you're happy with that. But a 1,000 percent markup isn't something that would happen in a competitive and free market."

Boschee said the wholesale electricity market is not yet a true commodity market, and it won't be until every industrial and residential customer in the Northwest and California pays market rates.
Tibbals agrees. He said that if residential consumers paid market prices for electricity then consumption would go down, and with it wholesale prices. He said that the supply and demand relationship in the electricity market isn’t working properly because a large segment of customers have been left outside of the market.

“We have to have a functional supply and demand relationship,” Tibbals said. “Demand has to drop, but it hasn’t because not enough people feel the pinch.”

Johnson blames a lack of competition, above all.

“There is not competition,” Johnson said. “There are a handful of suppliers, but they all quote bids at the market price. The index market was handed to (generators) on a silver platter, and now they control the market.”

PPL Montana, owner of what used to be the Montana Power Co.’s generating facilities disputes the diagnosis of a dysfunctional or manipulated market.

“In our region there is an enormous supply crunch,” said Rae Olson, spokeswoman for PPL Montana. “High electricity prices are a simple function of supply and demand.”

Olson said that PPL Montana’s hydropower is at about half production because of low water levels, forcing the company to buy electricity on the wholesale market at peak times to meet customers’ needs while absorbing the cost difference in the process.

John Hines, an economist and administrator for the Montana office of the Northwest Power Planning Council, said he would characterize the market in
California as dysfunctional, but noted that California is driving prices in the rest of
the region.

"There are definitely a lot of factors occurring at the same time that heighten the
scarcity problem in the Northwest," Hines said. "As long as you have a (limited)
supply prices are going to go up."

With a supply shortage in California and only small amounts of excess supply in
the Northwest, prices will rise. In addition, he said, the price of natural gas, which is
used to power much of the West's electricity plants, has gone up, further increasing
the cost of electricity.

But California's influence may wane as the wholesale electricity market changes,
Hines said.

"California became the price setter because of its shortages, but that is not
necessarily the case as more capacity in the Northwest comes online and transmission
capabilities limit it to in-state markets," Hines said.

Every company has dealt with the initial uncertainties of deregulation and the high
cost of electricity in ways it thought suitable to its business. But if those initial
uncertainties made Montana business managers nervous, the high prices of the last
few months have frightened them.

In October, Smurfit-Stone signed a five-year contract with Enron for 25 megawatts
of electricity, less than half of what it needs, at about $55 a megawatt, and more than
twice the price it paid two years earlier, Boschee said.
Since April the Smurfit-Stone facility is operating only the largest and most efficient of its three linerboard machines, or at 50 percent capacity. To supply the additional energy it needs, the plant is renting seven locomotive sized diesel-generators that cost between $100 a megawatt-hour and $120 a megawatt-hour to operate.

Boschee and his managers started to look for a new electricity contract last May, about six months before their first contract with Enron expired. Smurfit-Stone's electricity costs increased along with the wholesale price of electricity because of the index contract they had signed with Enron. Boschee and his managers initially resisted the temptation to lock in the price as the wholesale price increased because they believed, and were told by electricity generators and marketers they spoke with, that the price spike in May was temporary and prices would come down.

"The marketers' and generators' position was the price couldn't stay above $100 a megawatt-hour for an extended time," Boschee said. "They weren't trying to stiff us. Everyone thought the prices would moderate after the summer."

The wholesale price didn't come down, and the contract Smurfit-Stone eventually signed is a mixed blessing. The good news is it isn't paying $100 a megawatt-hour or more, the bad news is it must pay $55 a megawatt-hour for almost half its load into 2006, even if the market calms down and the price of electricity falls.

Signing long-term contracts of the kind Smurfit-Stone signed may be the only way forward for many of the industries in Montana over the next two years. Those
businesses that can't afford the market price available may have to cut back production or close down.

As they struggle to find cheaper electricity, Boschee and other industrial managers hope the laws passed by the Montana Legislature to encourage new generation facilities work sooner rather than later.
Chapter Four

Pennsylvania's Energy Market: A Beacon in the Darkness

Montana is struggling, but can learn from Pennsylvania's example

Henry Beaver, a retired railroad worker on a fixed income, isn't worried about his electric bill. He's happy with the service and says his rates are a real bargain. He even hopes to see them come down in the next few years.

But Beaver lives 1,600 miles away in Pennsylvania, the national poster child of electricity deregulation.

He's far from the turbulent electricity markets in the West and far from Montana, where deregulation wears a harsher face.

In Montana, 2,800 people have lost their jobs because of sky-high energy prices.

In Pennsylvania, state officials predict lower energy prices will create 36,000 new jobs by the year 2004.

In Montana, nearly 285,000 households served by Montana Power Co. will see a 50 percent increase in their power bills in the summer of 2002.

In Pennsylvania, homeowners like Henry Beaver are paying almost 20 percent less for electricity than they did three years ago. As of January, the state estimates its residential and commercial customers have saved nearly $3 billion due to deregulation.
Both states are pioneers in the movement to free utilities of government price controls, so why have they fared so differently? What does Pennsylvania’s power market have that Montana’s doesn’t?

The answer: Ready competitors with a healthy energy supply and an aggressive state program that manages competition.

"I think Pennsylvania's was one of the better deregulation plans in the United States," said Beaver.

The experts agree. For the second year running, the Center for the Advancement of Energy Markets, a nonprofit think tank, rates Pennsylvania No. 1 in the nation for its efforts to create a competitive energy market.

Being at the forefront of deregulation has helped Pennsylvania gain that edge, but the way the state organized and carried out its deregulation has kept it there.

From the start, Pennsylvania had six in-state utilities with close to $1 billion in power sales and new generation projects in the pipeline. Montana had, and still has, only one large generator competing for customers in the Montana Power territory and had no new generation projects in the pipeline until this year.

But the biggest factor is competition. Pennsylvania has aggressively broken down barriers and encouraged competition while Montana has waited for it to come knocking.

More than 500,000 of Pennsylvania’s five million residential customers have voluntarily switched to another supplier. That’s more than all other states combined and a reflection of the choices Pennsylvania customers have.

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The ability to choose is what competition is all about, but customers aren't used to shopping for power. Beaver, like thousands of other Pennsylvanians, has stayed with his incumbent utility, but only after looking at four or five competitive offers from other electricity suppliers.

In March, Beaver's electric bill was about $77 for the 879 kilowatt-hours he used. The generation component, the part competitors are vying for, was about $38 at 4.6 cents a kilowatt-hour. That's a little more than half the bill.

Montana Power customers pay about $56 for the same 879 kilowatt-hour bill. About $22 of that, at 2.4 cents a kilowatt-hour, is the generation component. That's about 25 percent less than Pennsylvania residents pay.

But, whereas Beaver's bill will is expected to stay the same or decline slightly over the next year, Montana Power customers' bills will rise 50 percent in the summer of 2002. That $56 bill jumps to more than $85. Now who's getting the bargain?

While Pennsylvania is falling out of the ranks of the most expensive electricity markets, Montana is doing the opposite and shooting up from the fifth lowest energy cost state to somewhere in the middle. And while competition is being stepped up in Pennsylvania, Montana is hoping to ride out the storm.

This spring, all the utilities in Pennsylvania are being forced to move customers like Beaver, who remained with his incumbent utility, to another supplier if they don't actively choose to remain. This alternative supplier won the right to serve those customers by offering the lowest bid among the competitors.
The most dynamic mark of success for Pennsylvania has been the sheer number of customers, about 700,000 households and 77,000 commercial businesses, who switched from their old utility to a competitor in the first two years of "customer choice."

Montana's energy market is anything but dynamic. A report prepared by the Montana Power Co. for Montana legislators showed that 1,000 Montana households had switched suppliers out of more than 285,000 eligible customers. But only 92 residential customers remained with an alternative supplier at the end of December 2000 and choice was limited to two in-state wholesalers and Montana Power.

Pennsylvania residential customers started switching suppliers in January 1999. Within four months, more than 300,000 residential customers had switched suppliers, representing about 10 percent of customers. But Pennsylvania is now in the process of making everyone, even households like Beaver's that haven't switched, participate in the process; they must either choose to stay put or be switched automatically to another supplier.

"You're still struggling with the mindset where people are not consciously switching providers, so you now have a program in which unless you opt to remain with your local company you will automatically be switched to a different supplier," said Christopher Craig, legal counsel for a Pennsylvania state senator and originally an opponent of deregulation. "A lot of ratepayers don't want to switch because they are comfortable with the service they receive."

This spring, PECO Energy Inc., the incumbent utility in the Philadelphia area, had 250,000, or about 18 percent, of its customers switched to a competing supplier. Customers can opt-out of the program or choose another supplier without penalty, but they
have to make the choice. By the time the process is complete in all the Pennsylvania utility areas, close to half of Pennsylvania's residential customers will be with an electricity supplier other than the utility that has served them for years.

Not everyone is happy with the idea of being moved to another supplier, but the aim is to make a competitive market by breaking the lock of the incumbent suppliers and forcing consumers to actively participate in the process.

Kathy Hahesey, of Erie, Pennsylvania, said she and her husband considered switching suppliers and even called a number of them to get information. They also talked to their neighbors and friends, but eventually decided to stay with their incumbent utility.

"We don't want to switch," she said. "We feel we made an educated decision back in 1997 and would like to stay where we're at."

Hahesey, Beaver, and many other Pennsylvania residents checked out the options and stayed put. But they had more than the one option Montana has been faced with.

"Customer choice" in Pennsylvania is a reality because the government is, in part, creating it.

"The governor (Tom Ridge) showed leadership in putting things together for deregulation," said Sonny Popowski, head of the Pennsylvania Consumer Advocate office, who was active in the deregulation process.

He said that the views of consumers, business and industry, regulators, and the utilities all contributed to the drawing up of the deregulation legislation in 1996. Most participated in order to have a say in something that would affect them and that would likely pass in one form or another, and that the governor encouraged everyone's participation.
"Not everyone got what they wanted, but most got what they needed," Popowski said.

"All of the major interests had a say."

In Montana, the Montana Power Co. and large industry pushed deregulation. They got what they wanted at the time. Montana's cooperatives wrangled an opt-out, leaving the residential consumers in Montana Power's territory with the weak protection of a transition period and assurances that the market would take care of the rest.

Pennsylvania left nothing to chance. It negotiated electricity generation and distribution charges with each utility. These prices, setting a cap on what incumbent utilities could charge, became the basis of competition, and were either the same as under regulation or slightly less for residential customers. The idea was that Pennsylvania's prices were already high compared to other parts of the country, primarily because of expensive nuclear power plants. So they wouldn't lower prices artificially, but allow competition to drive them down and save consumers money.

"The rate caps were set at a level that allows competition," said Popowsky. "The most important thing for consumers is the price cuts. Prices in 1996 were high to begin with, and even after the price caps about 10 percent of residential customers have still voluntarily switched suppliers and saved money."

Montana followed a different logic in setting its residential rates for the transition period.

Tom Power, a professor of economics at the University of Montana and an active participant in the deregulation debate from the start, said the assumption was that deregulation would encourage power plant construction and competition. But Montana set
the residential customers price cap at the 1994 level, a price that turned out to be below the
cost of new production. It's simple: if a company can't cover its costs it's not going to
build a power plant.

"We did something similar to what California did. We promised to protect consumers
for the first four or five years with the price set at the cost of producing from Colstrip and
the dams," Power said. "Pennsylvania prices were higher than that and customers are
being raffled. Customers don't have to make a choice, they are simply being divided, and
so competition is given a jump start."

Recently a few clouds have been gathering, threatening to rain on Pennsylvania's
deregulation parade as neighboring states have experienced supply crunches.

"Wholesale prices in the East are going up, making it harder for marketers to compete
with the (negotiated rates) that the utilities are charging," Popowsky said. "So the number
of firms competing for customers in Pennsylvania has declined in the past year because
they can no longer lure customers to their service with lower prices."

Popowsky isn't worried though, because he said Pennsylvania will get more
competitive as time goes by.

Beaver isn't worried either. He said he expected some of the competitors to leave
anyway.

"I'm not anxious to switch until the market is settled out," he said. "That's why I've
stayed with my utility."

No one seems worried about a California type crisis in Pennsylvania either. Experts in
the state point to the differences, such as relatively high negotiated prices, hedging through
long-term contracts, and the amount of generation coming on-line in the next few years, as proof of stability and greater success to come.

John Rohrbach, an energy expert for the non-profit organization PennFuture, said the higher wholesale prices are temporary and that customers will still save money on electricity in the long run.

One of the surprises in Pennsylvania, according to Craig, has been the success of a company selling "green energy." The power Green Mountain Energy sells in Pennsylvania is primarily from clean-burning natural gas plants and also includes energy in different amounts from wind turbines, hydropower, biomass, or any other renewable energy source.

Green Mountain has signed up more than 30,000 customers and is set to gain another 50,000 in the Philadelphia area in the coming months despite charging one to 2 cents a kilowatt-hour more for the electricity they sell.

Montana's business and political leaders hope to emulate all of Pennsylvania's successes. Shane Hedges, the governor's chief policy advisor, said that although Montana has made mistakes, it's heading in the right direction and learning from what Pennsylvania had done.

He said that Pennsylvania had the foresight to build the generation it needed during the transition to a free market so that there was competition. Montana did not, and is now catching up.

"The Pennsylvania model of deregulation is a perfect example that if you planned deregulation appropriately it will work for the benefit of consumers," he said.
Chapter Five

Looking for Competition in Montana’s Energy Market

One company's frustrating search for energy

Ralph Denoski used to spend 12 hours a year hunting for the energy to keep his Bozeman-area cement plant operating.

Now he spends 30 hours a week.

"It's become a daily thing to look at the market and see what's available," he said.

"We're doing what we can to nail down a contract."

But, he said, the search has been extremely frustrating.

He's checked with the companies on the Public Service Commission's licensed suppliers list and in-state and out-of-state suppliers that aren't on the list. He's even checked into renting diesel generators, anything to get him the electricity he needs. But he can't find the energy to meet his needs and he's not sure what he's going to do.

He has until July, when his company's current contract ends, to find affordable electricity or figure out some other way to power the plant.

"Dysfunctional" is a word Denoski and many other Montana industrial managers have used to describe the electricity market in the Northwest, a market that once seemed so promising. When he started looking at contracts in 1998, after entering the deregulated market to seek cheaper power, he found it easy to get contract offers from marketers and generators at prices he could afford.
“We were tied to the regulated market for so long we had to test the market,” he said. “We wanted to know what was out there and what was available before jumping in. It went quite well.”

All of that has changed.

Now, he said, he sees little competition. With his own business susceptible to price swings, he needs the flexibility one and two year electricity contracts offer. But the only contracts in his price range are for three to five years, a commitment he can’t make. So he’s waiting for electricity prices to come down after 2002, when more power plants are expected to come on line.

Although there are 21 licensed electricity suppliers in the Montana Power Co. territory, Denoski says he can’t find one to offer him a competitive bid. Most of them are marketing companies that sell power based on wholesale market prices, and few of which are signing contracts at this time. Only one company on the list, PPL Montana, is a power generator of significant size in Montana. Competition is scarce.

Denoski’s company and other Montana industrial customers have generally two options when purchasing electricity: companies that generate the electricity, and marketers that buy electricity from generators, market and repackage it, and sell it at a profit.

At the end of 2000, according to a Montana Power report compiled for legislators, 87 of Montana Power’s 246 eligible industrial customers moved into the deregulated market and were buying electricity from licensed competitors. These 87 companies represented 57 percent of Montana Power’s large industrial load.
Industrial customers like Denoski left the regulated market because the wholesale market prices were lower in 1997 when the deregulation law passed. At less than $25 a megawatt-hour in the wholesale market, Denoski and others saw no reason to pay Montana Power Co. $28 a megawatt-hour in regulated generation rates. The savings were a powerful incentive for energy intensive industry to move from the regulated market and into the unregulated wholesale market.

Denoski and many of Montana's industrial companies signed contracts with large wholesalers like Enron Corp. and Duke Energy in 1998, and a few signed contracts with PPL Montana. The small wholesalers in Montana have yet to make their mark and no out-of-state utilities or generators are significant players in Montana's electricity market right now.

Of the 21 licensed suppliers that Denoski and other Montana industrial customers have to choose from, nine don't sign contracts with industrial customers. So only 12 are truly suppliers for industrial customers.

Two companies listed as suppliers tested the waters and pulled out of the market. Three of the companies only sell to other marketers, utilities and wholesalers. And four of those listed, the Montana League of Cities and Towns, the Montana School Boards Association, the Town of Philipsburg, and the City of Helena are only on the list because they buy electricity for their own use.

Of the remaining 12 suppliers, two of the three out-of-state electricity generators listed as licensed suppliers aren't actively pursuing customers at this time due to their own supply shortages.
One of these out-of-state suppliers is Granite Peak Energy, the marketing arm of Basin Electric Cooperative based in the Dakotas and Wyoming. Jim Davies, the chief executive officer, said he has two clients in Montana using about a 12 megawatt load between them both. That 12 megawatts isn't much of a dent in the Montana electricity market when you consider the residential customers and businesses in Montana Power's territory regularly use more than a 1,000 megawatts of electricity. He said those two contracts were signed before the market sky rocketed.

"Now we aren't really doing any marketing," he said. "Every once in a while we'll get a call because we are on the list of providers by the PSC. But they hear the price we're quoting and are not interested. The price is so high right now no one is purchasing."

Jeff Schaus, spokesman for the only active out-of-state supplier, Idaho Power Co., said that it's marketing arm does have long-term contracts with a few commercial businesses in Montana and is actively pursuing contracts with others. But he also said the marketing arm is separate from the regulated utility that generates electricity for its Idaho customers.

The marketing arm gets most of the electricity it sells on the wholesale market and not from electricity generated by Idaho Power. In fact, Idaho Power is buying electricity on the wholesale market to meet its regulated customers' needs and will be using 25 mobile diesel generators starting May 1 to meet summer demands, so they don't have any excess capacity at this time.

With two inactive out-of-state suppliers the list is shortened to 10 active suppliers, five of which are small Montana-based marketers.
All five of the small Montana-based marketers on the list have been pushed to the sidelines by high wholesale electricity prices. When wholesale prices fall these small marketers will be able to help their customers out again, but until then they’ll remain on the sidelines.

Denoski, his own business struggling with power issues, said he feels sorry for these small marketers because right now they don’t have much to offer generators that will get them contracts and electricity to sell to customers.

The electricity market is just as frustrating to Jim Morin, from the Montana-based marketer Energy West Resources.

"It's very difficult to cultivate competition until there is adequate supply out there," Morin said. "It's a very risky business. Most marketers do nothing more than buy and sell power. We're in the place to find the best price for customers. You can't buy power without someone to purchase it otherwise you get stuck with the costs."

As a result, Energy West has only one long-term electricity contract. It’s with the Montana League of Cities and Towns and the Montana School Boards Association and runs through June 2002, but that contract was signed about a year ago before wholesale prices skyrocketed.

Another Montana-based marketer, Glacier Energy has no customers right now, and as long as wholesale prices remain high it looks to stay that way.

"So far we haven't been able to place competitive bids," said Bill Chapman, general manager of Glacier Energy.
He said because they have to go to a generator to find their electricity it's more difficult to compete on price. Most customers go directly to the generators, cutting him out. Chapman said requests for quotes on electricity contracts grew as the prices in the wholesale market went up, in May through December, but then dropped off.

With the five small Montana-based marketers out of the picture, the suppliers list dwindles to five.

Only the heavy hitters are left on the suppliers list.

Of the five remaining options for Denoski and Montana industry, four are large national marketers and one is PPL Montana, the only generator selling large amounts of electricity in the Montana Power territory.

The four large energy marketing companies have the money, experience and depth of customers that allows them to buy long-term energy contracts whether or not a client is lined up to buy the electricity. If these marketers are active in the Montana electricity market then Montana's business and industry might have a chance. If not, then Montana's power market is non-existent.

Right now all of the marketers say they are active, but that doesn't mean Denoski and other industrial customers can afford what they are offering. Enron Energy Services has a number of customers on contract already and has been active in pursuing industrial customers in Montana.

Peggy Mahoney, communications director at Enron Energy Services, said that whether or not they sign long-term contracts depends on the rules of the market in each state, meaning whether or not it is deregulated. She said that if it makes economic sense to lock
up electricity in a particular market they do it, but if not they buy on the spot market to
meet their customers needs.

But the driving factor for pricing their contracts is the wholesale market price. Right
now that price is about $200 a megawatt hour. For Denoski and Montana industrial
customers to get that price down to the $50 a megawatt hour range they have to sign long-
term contracts of three years or more. But to Denoski and others that’s still too high a
price, with too long a commitment, when expectations are that prices will come down in
the next two years as more generation capacity comes on line.

With the four large marketers competing in Montana but not offering affordable
contracts, Denoski and other industrial customers have one more licensed supplier to turn
to, PPL Montana.

If Denoski and Montana industrial customers can’t get affordable power from these
marketers, surely they can get power from PPL Montana, the generator that supplies most
of Montana Power’s customers with electricity?

Although PPL Montana may be able to sell the electricity it generates at a price lower
than the wholesale price and make a profit, it doesn’t have to under deregulation.
Marketers, however, have no choice.

PPL Montana announced a deal last week to sell power to Montana Power customers
for $40 a megawatt-hour. But so far it has refused to offer the same deal to industrial
customers.
"PPL Montana hasn't shown any willingness to work with us on a contract," Denoski said. "The contract proposals we get back from PPL are the same price as what other suppliers offer."

Rae Olson, a spokeswoman for PPL Montana, said the company doesn’t have enough energy to supply all of the industries in Montana, and what they do have is for their clients who have already signed contracts.

"Our hydropower is at about half production because of low water levels," Olson said.

At times of peak usage, it buys power in the wholesale market, which makes it expensive.

Other generators in Montana, like the Bonneville Power Administration and Avista Corporation have customers, primarily rural cooperatives or regulated customers, that use all the electricity they generate. And the generation from their dams is diminished from low water levels and drought as well.

Avista Corp., although regularly mentioned by some legislators and industrial customers, is not pursuing customers in Montana. Robyn Dunlap, from Avista’s corporate communications office, said it is not a supplier of electricity in Montana, and that it has very limited participation in the Montana wholesale market.

PPL Montana, then, is the only electricity generator of significant size in and around Montana that sells to customers in the Montana Power utility distribution area. All the remaining competitors are large out-of-state marketers.

With only one in-state generator, Montana doesn't have much influence on the price of electricity.
In fact it's been the opposite. Montana and its industrial customers are being forced to pay electricity prices that have more to do with the supply crunch in California and other Northwestern states like Washington and Oregon.

"Montana is a hostage to the situation in California," Denoski said. "It makes it a market that we can't control."

After all of his struggles to find affordable electricity, Denoski still believes that deregulation was the right way to go. He’s certain a competitive market will develop with time.

In the meantime, Denoski and other industrial customers are going to have to sign three-year to five-year contracts to get the prices they can afford, or their going to have to use diesel generators or other short-term power sources as they wait for prices to come down.
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