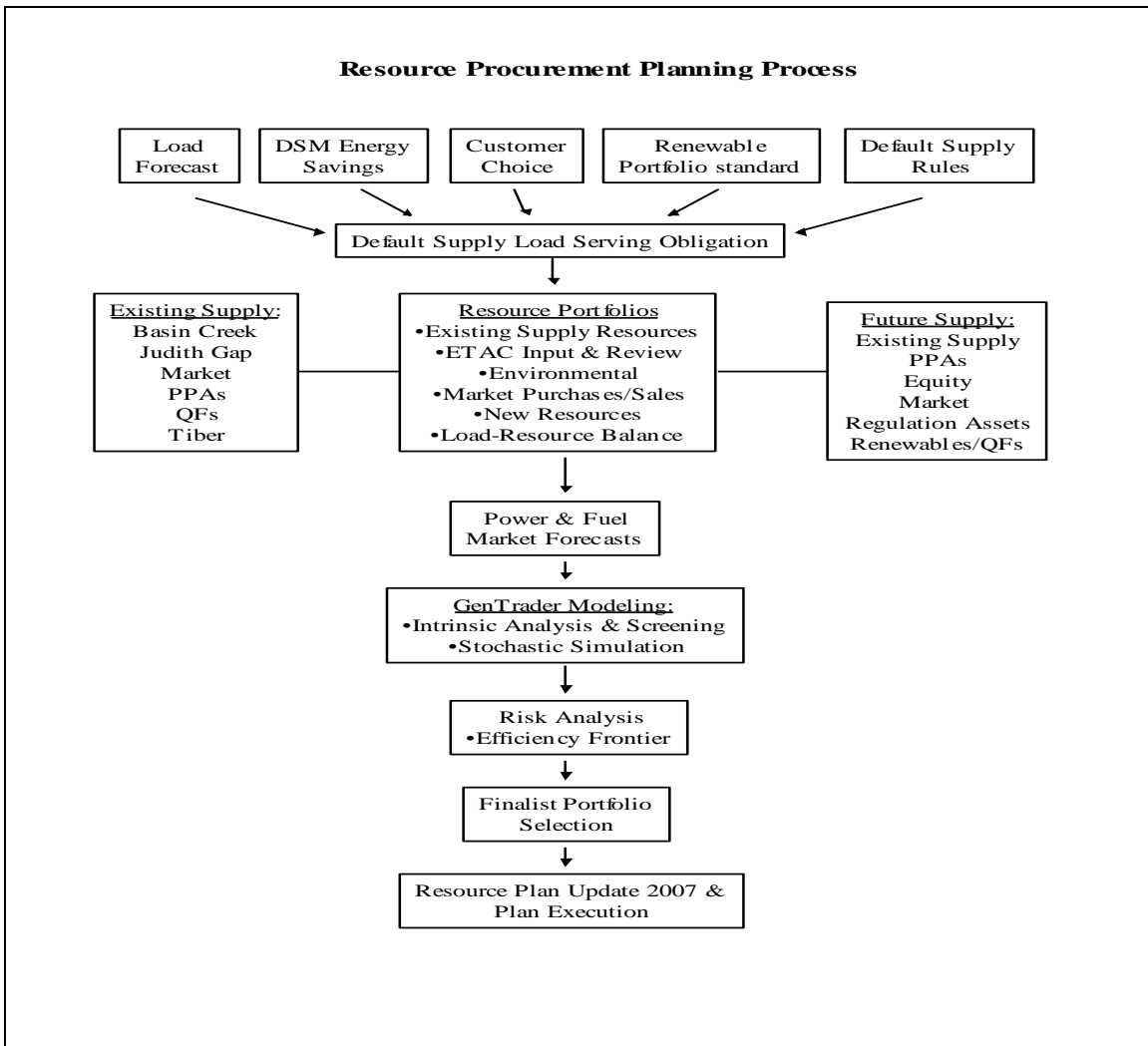


Chapter 1 Background

NorthWestern's Planning Process

The 2007 Electric Supply Resource Procurement Plan details NorthWestern's systematic efforts to plan for the procurement of a portfolio of electric resources consistent with statutes and Montana Public Service Commission rules. Consistent with the Electric Utility Resource Planning and Procurement Rules (ARM Title 38, Chapter 5, Subchapter 82) (the "Guidelines"), this Plan details NorthWestern's efforts to provide an adequate, reliable supply of electricity that is both stably and reasonably priced. Figure 1-1 below provides an illustration of NorthWestern's planning process.

Figure 1-1, Resource Planning Process



The basic analytical steps involved in developing this Plan are:

- Forecasting the load to be served over the next twenty years;
- Decreasing the forecast by the estimated energy conservation for the DSM planning horizon;
- Developing a market price forecast for electricity – modified to reflect the effects of the imposition of a future CO₂ tax;
- Accumulating a data set of resources and their corresponding characteristics that are used as model inputs;
- Developing low, medium, and high CO₂ tax scenarios;
- Creating various portfolios of resources (to represent the feasible resources that NorthWestern could pursue);
- Identifying and subsequently analyzing key risks to the supply portfolio including electricity and natural gas price risk and carbon tax risk;
- Analyzing the costs of the various portfolios and selecting the best options (considering the costs and major risk factors inherent in each);
- Selecting and performing a qualitative analysis of the best portfolios; and,
- Creating an Action Plan with items for NorthWestern to undertake over the next three years and beyond.

While this Plan provides significant guidance to the utility, it is intended to also provide the MPSC and stakeholders an opportunity to understand the critical issues associated with the ongoing development of the electric portfolio.

ARM 38.5.8203 states that the Guidelines will provide the basis for Commission review of resource acquisitions. Thus this Plan, coupled with Commission comments, sets a basis or framework for evaluating NorthWestern's procurement actions and provides expectations of cost recovery so long as NorthWestern's actions are consistent with the Plan and the Commission's comments. Future actions may in some cases deviate from what is set forth in this Plan. Any such actions will fully document the reasons why such deviations occurred.

Development of 2007 Electric Supply Procurement Plan

Context for Plan Development

Most of the regulatory framework, including statutes, Montana Administrative Rules, and MPSC policies have remained unchanged since the 2005 Plan was developed. However, there have been a couple of important exceptions that do affect the 2007 Plan and they are discussed below. In addition, Volume 2, Chapter 1 contains a list of issues that were raised by the MPSC regarding the 2005 Plan and how NorthWestern has addressed them during the past two years.

Qualifying Facility Rulings

The Commission has initiated several processes to determine the future structure of Qualifying Facility (“QF”) purchases by NorthWestern. (See Volume 2, Chapter 1 for more detail.) There are currently three tariff rate options developed by the Commission from which prospective suppliers can choose. In addition, the Commission recently increased the size limit of QF’s that would qualify for long-term contracts from 3 MW to 10 MW. NorthWestern has seen a significant increase in interest from potential QF suppliers based on the Commission’s recent actions. NorthWestern believes that the Commission’s recent decision to expand the size of eligible QF projects may significantly increase the amount of QF resources in the portfolio. Nearly all of the current inquiries from the larger potential QF suppliers have been related to wind energy projects.

House Bill 25

The Montana legislature passed and the Governor signed House Bill 25 (“HB 25”) into law, amending the Electric Utility Industry Restructuring and Customer Choice Act and renaming it as the “Electric Utility Industry Generation Reintegration Act.”² See Volume 2, Chapter 1 for the entire Act. HB 25 contains

² Lines 18-19, page 4, Authorized Print Version of HB 25 (HB0025.05).

a number of changes to the laws affecting NorthWestern Energy as the default supplier within its service territory. The main changes are:

- Retail customers will no longer be allowed to change their electricity supplier from the local utility to an alternate electricity supplier. Retail customers that currently take service from an alternate supplier may continue to do so, but if they ever take service from the local utility, they will not be able to switch back to an alternate supplier.³
- The notion of a “default supplier” is eliminated in favor of the more traditional “public utility”.
- The public utility is charged with prudently planning and acquiring resources to serve its resource needs. The public utility may acquire these resources in the form of power purchase agreements, lease agreements, or through equity participation in a generating facility.⁴
- The MPSC shall issue its approval or denial of electricity supply resources that are not yet procured on a specified time schedule. Approval will constitute approval of the recovery of costs of the approved resource in rates.⁵
- For any natural gas or coal fired rate-based resource proposed for approval by a public utility prior to construction, the utility will be required to implement carbon offsets.⁶

Recent Actions That Affect The Portfolio

The portfolio’s load resource balance in 2007 reflects the substantial resource acquisitions that have been achieved since the 2005 Plan was completed. NorthWestern developed and conducted a pilot auction, finalized a contract with PPL Montana, executed a contract for the purchase of 90 MW of unit contingent

³ IBID pages 12-14.

⁴ IBID section 13.

⁵ IBID section 15.

⁶ IBID pages 24-25.

power with Montana Generation, LLC (“MG”), participated in a PPL Montana RFP-type solicitation which resulted in an 18-month contract for 52 MW, and entered into a settlement with BPA regarding its share of the Residential Exchange Program (“REP”) benefits whereby BPA will provide our residential and small farm customers monetary benefits.

Residential Exchange

The Federal Columbia River Power System, which is managed by the Bonneville Power Administration (“BPA”), provides benefits to customers throughout the Pacific Northwest. The small farm and residential customers of Investor Owned Utilities (“IOU”) in the Pacific Northwest receive financial or power benefits per the REP of the Northwest Power Act. NorthWestern, in September 2000, entered into a settlement with BPA regarding its share of the REP benefits whereby BPA provided our residential and small farm customers monetary and power benefits.

The BPA, following a Ninth Circuit Court of Appeals decision, suspended REP payments in April 2007. Subsequent to the Ninth Court decision, the IOUs, including NorthWestern, entered into discussions with regional public utilities to attempt to resolve the issues associated with the Ninth Circuit Court of Appeals decision. These discussions are ongoing and have resulted in some progress. An agreement has been reached with the public utilities in the Pacific Northwest that will facilitate resumption of benefits from the Federal Columbia River Power System to NorthWestern customers. The new contract will be consistent with the intent of the Northwest Power Act.

NorthWestern anticipates a resumption of the flow of monetary benefits possibly as early as January 2008 based on an interim agreement. NorthWestern benefit levels were approximately \$3.8 million per year prior to the suspension of payments. Interim benefits should be approximately equal to the previous benefit levels. When the new methodology, allocation, and subsequent contracts are

completed (estimated to occur by late 2008), benefits should increase to about \$7.0 million to \$7.3 million per year for NorthWestern Energy's qualifying customers. NorthWestern anticipates the new contracts will be for up to a 20-year term, and should provide stable benefits to our customers. This will result in a rate decrease of approximately \$2 a month for residential and small farm customers.

Pacific Northwest Landscape

Introduction

A number of significant developments have occurred influencing the regional resource planning environment and the management of long-term power supply portfolios since NorthWestern released its last plan in 2005. (See Volume 2, Chapter 1, Pacific Northwest Landscape, for a complete discussion.) Some of the key regional issues are:

1. Regional state legislatures and regulators have renewed their focus on reliable long-term resource planning and have challenged some of the assumptions about resource adequacy. One example is the review of hydropower resources. Given the vagaries of stream flows and continuously evolving non-power requirements on the hydro system, hydro generation output is not nearly as reliable as historically portrayed in planning processes.
2. Given continued high and volatile electricity prices, to what extent should utilities rely upon the wholesale power market for resources on a planned basis? A number of large regional utilities are forecasting significant resource deficits into the future.
3. Renewable resource mandates are becoming commonplace in the form of Renewable Portfolio Standards.
4. Societal concern about the impact of CO₂ emissions on global climate change has created uncertainty about potential future costs associated with a carbon tax and has called into question the reliance upon coal resources, even in the form of the relatively cleaner IGCC technology (see

- Chapter 5 for a description of IGCC technology.) Certain innovative coal technologies identified in the National Energy Policy Act of 2005 as eligible for incentives and loans do not have policy level support in the states of California and Washington. Montana legislation has been developed that sets carbon offsets or sequestration requirements for NorthWestern if both an equity interest in new or existing gas or coal generation in Montana is acquired and NorthWestern seeks Commission approval of the electricity supply resource.
5. A number of utilities, including NorthWestern, have brought on significant amounts of new wind resources in the last two years, but recent work facilitated by the Northwest Power & Conservation Council (“NWPCC”) has called into question the firming and integration impacts of these resources. The region is still working to determine how much additional wind resource can be economically supported.
 6. A number of transmission projects have been proposed and some are currently in the study and development stages. These include, among others, the Montana Alberta Tie Line (“MATL”), Idaho and PacifiCorp’s proposed Wyoming, Utah and Idaho transmission projects, the Mountain States Transmission Intertie (“MSTI”), and the proposed Northern Lights project to Alberta.

The combination of these factors and the uncertainty related to them has created an environment supportive of the development of new renewable resources but not supportive of conventional base-load and peaking resources. The quantity and type of renewable resources are insufficient to meet projected load growth and regional deficits.

In the face of this significant uncertainty in the areas of future carbon and other emissions regulations, Investor Owned Utilities’ (“IOUs”) Supply Plans are indicating a low-risk approach to resource additions and are placing even greater emphasis on resource additions that minimize the amount of risk and uncertainty

the utility bears into the future. IOUs are also seeking advance assurances from regulators to the extent possible to maximize the likelihood cost recovery will be granted for their long-term resource additions. As a result, it appears utilities will explicitly or implicitly rely upon the short-term market for either spot or short-term bridging supplies that will give them an opportunity to secure long term supplies after some of the uncertainties are resolved.

While there are a few forecasts, including the NWPPC's, which indicate a positive regional load resource balance, Bonneville Power's forecast and the 2007 Northwest Regional Forecast ("NRF") study prepared by the Pacific Northwest Utilities Conference Committee ("PNUCC") paint a somewhat bleak outlook for northwest load and resource projections⁷. Table 1-1 below shows PNUCC projections for the next 10 years.

Table 1-1, PNUCC 2007 Northwest Regional Forecast

Annual Energy (MWh)	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Requirements										
Load	21,371	21,831	22,141	22,444	22,711	23,049	23,348	23,655	23,972	24,197
Exports	828	773	866	827	773	735	722	674	618	555
Total	22,198	22,604	23,007	23,271	23,484	23,784	24,070	24,329	24,590	24,752
Resources										
Hydro	11,480	11,478	11,496	11,487	11,486	11,484	11,483	11,481	11,481	11,481
Small Thermal & Miscellaneous	24	24	24	24	24	24	24	25	25	25
Combustion Turbines	1,516	1,526	1,518	1,535	1,496	1,516	1,509	1,518	1,503	1,516
Renewables	802	868	872	871	862	855	856	846	845	845
Cogeneration	1,151	1,148	1,152	1,150	978	831	743	745	745	745
Imports	1,684	1,525	1,218	1,016	719	719	722	722	726	581
Large Thermal	4,523	4,329	4,404	4,397	4,562	4,374	4,617	4,494	4,560	4,494
Total	21,181	20,899	20,684	20,480	20,127	19,803	19,953	19,831	19,884	19,686
Surplus (Deficit)	(1,018)	(1,705)	(2,323)	(2,791)	(3,357)	(3,981)	(4,117)	(4,498)	(4,706)	(5,066)
Potentially Available Resources										
Independent Power Producer Projects	3,086	3,086	3,086	3,086	3,086	3,086	3,086	3,086	3,086	3,086
Hydro Generation (70 year average)	4,181	4,179	4,160	4,170	4,171	4,172	4,174	4,175	4,176	4,176

⁷ PNUCC is a northwest utility organization that performs a variety of analytical work on behalf of its members.

The NRF report projects that under the critical water planning criteria, the region is currently deficit by 1,018 aMW. Average water provides an additional 4,181 aMW and Independent Power Producers (“IPPs”) can provide another 3,086 aMW from existing resources that are not committed to Northwest loads at this time.

The NRF shows that even using IPP resources uncommitted to load, the region will experience a firm energy deficit in five years under the critical water planning standard. The reliance on IPP resources may be somewhat optimistic. These resources are on the order of 3,263 MW of installed capacity and are not currently contracted to utility load service⁸. In an instance of tight supply the region can expect that these resources will respond to market drivers and operate to meet local needs. On a long term planning basis, however, it cannot be known if IPP resources that are not under contract can be relied upon to meet firm regional loads. Extra-regional markets may attract this supply even though it is needed in the Northwest. Without contractual rights to these projects, regional utilities are also not in a position to hedge future fuel costs and therefore are exposed to substantial price risk in the wholesale power markets.

Conclusions

In summarizing the status of the utility landscape in the Pacific Northwest, the overriding theme is the uncertain environment in which resource decisions and acquisitions are taking place. There is tremendous risk and uncertainty confronting utilities and regulators.

Regarding future regional load/resource conditions, the apparent difficulty in deciding whether to construct new baseload resources to serve continued load growth raises the specter of significant shortfalls in the future which will exacerbate the volatility of an already volatile energy commodities market. In the

⁸ Table 7 from PNUCC’s 2006 Northwest Regional Forecast.

event utilities do manage to construct new coal or baseload plants, it is assumed that some form of carbon assessment – either in the form of a carbon tax or a cap and trade process – will make up a piece of the resources cost. Deriving a reasonable estimate of these cost adders and their resulting impact on the market and other resources costs is nearly an impossible task. As a result of the high level of uncertainty, regional utilities appear to be focused on the development of smaller scale renewable resources, DSM, planned reliance on the wholesale market, and avoiding significant investments in new thermal generation. NorthWestern approaches this environment as a utility with a recognized substantial resource deficit beginning in 2014.