

MPUC Docket No. E-6472-/M-05-1993

OAH Docket No. 12-2500-17260-2

BEFORE THE
MINNESOTA OFFICE OF ADMINISTRATIVE HEARINGS
100 Washington Square, Suite 1700
Minneapolis, Minnesota 55401-2138

FOR THE
MINNESOTA PUBLIC UTILITIES COMMISSION
127 7th Place East, Suite 350
St. Paul, Minnesota 55101-2147

In the Matter of the Petition of Excelsior Energy Inc.
and Its Wholly-Owned Subsidiary MEP-I, LLC For Approval of Terms and
Conditions For The Sale of Power From Its Innovative Energy Project Using
Clean Energy Technology Under Minn. Stat. § 216B.1694 and a
Determination That the Clean Energy Technology Is Or Is Likely To Be a
Least-Cost Alternative Under Minn. Stat. § 216B.1693

**REBUTTAL TESTIMONY AND EXHIBITS OF
EXCELSIOR ENERGY INC. AND MEP-I LLC**

MICHAEL J. HAMILTON

OCTOBER 10, 2006

1 **EXCELSIOR ENERGY, INC.**

2 **BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION**

3 **PREPARED REBUTTAL TESTIMONY OF**

4 **MICHAEL J. HAMILTON**

5 **I. INTRODUCTION AND QUALIFICATIONS**

6 **Q Please state your name.**

7 A My name is Michael J. Hamilton.

8 **Q By whom are you employed and what is your position?**

9 A I am a Senior Managing Director in the Corporate Finance Division of FTI
10 Consulting, Inc. and am responsible for Corporate Finance energy-related services.

11 **Q For whom are you testifying?**

12 A I am testifying on behalf of MEP-I LLC and Excelsior Energy Inc. (collectively
13 “Excelsior”), the developers of the Mesaba Energy Project (the “Project”).

14 **Q Please summarize your qualifications and experience.**

15 A I received a Bachelor of Science degree in accounting from St. Francis College
16 in 1969. I am a certified public accountant in the District of Columbia and in several
17 other states. I started my career working for Arthur Andersen & Co. in that firm’s
18 regulated industry practice. I left them after 10 years as an audit manager and was
19 employed by the Potomac Electric Power Company (“PEPCO”). At PEPCO, I worked
20 in substantially all of the financial departments including corporate accounting, general
21 accounting, property accounting, ratemaking, payroll, accounts payable, financial

1 forecasting and worked on a number of special projects. I was also active in the Edison
2 Electric Institute during this time and testified before the Financial Accounting
3 Standards Board (the “FASB”) with regard to the electric industry positions as the
4 FASB considered changes to the then existing generally accepted accounting principles
5 related to tax accounting requirements.

6 I joined Price Waterhouse & Co. (“PW”) in March of 1988 and became an audit
7 partner in 1990. Subsequently, I was placed in charge of the domestic utility audit and
8 tax practice. When PW merged with Coopers & Lybrand to form
9 PricewaterhouseCoopers LLP (“PwC”), I retained my responsibility for the combined
10 domestic utility audit and tax practice. I have been the audit partner on a number of
11 significant audit engagements including Consolidated Edison Company of New York,
12 PPL, Inc. and Illinova, among numerous others. I also have significant experience in
13 working in numerous utility and energy company restructurings and bankruptcies.

14 I retired from PwC at the end of February 2003 and joined FTI Consulting, Inc.
15 as a Senior Managing Director in the Corporate Finance Division where I lead my
16 firm’s energy practice.

17 My resume, which contains a more detailed description of my experience and
18 qualifications, is provided as Exhibit __ (MJH-1), Schedule I.

19 II. OVERVIEW

20 **Q What is the purpose of your testimony?**

21 **A** The purpose of my testimony is to address the conclusions that Marvin E.
22 McDaniel reached in his direct testimony filed on September 5, 2006 and to provide my
23 insights with regard to his conclusions.

1 **Q Please summarize your conclusions.**

2 **A** Based on my review of the changes that Excelsior Energy has proposed to the
3 Mesaba 1 Power Purchase Agreement (“Mesaba 1 PPA”), I believe that

4 1. The Mesaba 1 PPA appears to be consistent with the Northern States Power
5 Company Model Dispatchable Power Purchase Agreement model (the “NSP Model
6 PPA”) and other power purchase agreements (“PPAs”) have been signed based on
7 this model and not been capitalized.

8 2. Mr. McDaniel has appropriately identified the relevant accounting pronouncements
9 that need to be considered in determining the appropriate accounting for PPA
10 contracts.

11 3. These accounting pronouncements are extremely complex and fact driven and I
12 believe that it is premature to make sweeping pronouncements of the applicability of
13 these pronouncements to the Mesaba 1 PPA.

14 4. The concerns that Mr. McDaniel expresses with regard to the Mesaba 1 PPA appear
15 to exist in at least one other PPA that Northern States Power (“NSP”) has recently
16 signed, but that contract does not appear to have been capitalized.

17 5. The electricity purchased by NSP under the Mesaba 1 PPA will be treated as a
18 normal purchase / normal sale in accordance with Statement of Financial
19 Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging
20 Activities (“FAS 133”) and this accounting will eliminate any financial statement
21 volatility due to changes in the fair value of the electricity to be purchased.

1 **Q On what do you base your conclusions?**

2 A My conclusions are based on an analysis of the Mesaba 1 PPA and the
3 application of the relevant Generally Accepted Accounting Principles (“GAAP”) to that
4 PPA.

5 **III. ACCOUNTING STANDARDS DISCUSSION**

6 **Q The basic question is whether NSP will have to either consolidate the Mesaba 1**
7 **PPA or record it as a capital lease.**

8 A Mr. McDaniel has raised issues about the appropriate accounting by NSP of the
9 Mesaba 1 PPA. Under certain conditions, NSP could be required to either consolidate
10 the Mesaba 1 PPA or account for it as a capital lease (which accounting has a similar
11 effect) in the financial statements of NSP. The relevant accounting standards to consider
12 in this regard are Financial Accounting Standards Board Interpretation No. 46 (R),
13 Consolidation of Variable Interest Entities—an Interpretation of ARB [Accounting
14 Research Bulletin] No. 51 (“FIN 46 (R)”) and Emerging Issues Task Force Issue
15 No. 01-08, Determining Whether An Arrangement Contains a Lease (“EITF 01-08”)
16 and Statement of Financial Accounting Standards No. 13, Accounting for Leases
17 (“FAS 13”).

18 **Q Please discuss the accounting requirements of FIN 46 (R).**

19 A FIN 46 (R) was promulgated as a direct result of the bankruptcy of Enron
20 Corporation and the abuse of the accounting for special purpose entities that played a
21 role in that accounting scandal. As stated in FIN 46 (R), the reason for issuing this
22 interpretation is as follows—

23 Transactions involving variable interest entities have become increasingly
24 common, and the relevant accounting literature is fragmented and incomplete.

1 ARB 51 requires that an enterprise’s consolidated financial statements include
2 subsidiaries in which the enterprise has a controlling financial interest. That
3 requirement usually has been applied to subsidiaries in which an enterprise
4 has a majority voting interest, but in many circumstances the enterprise’s
5 consolidated financial statements do not include variable interest entities with
6 which it has similar relationships. The voting interest approach is not effective
7 in identifying controlling financial interests in entities that are not controllable
8 through voting interests or in which the equity investors do not bear the
9 residual economic risks.

10
11 The objective of this Interpretation is not to restrict the use of variable interest
12 entities but to improve financial reporting by enterprises involved with
13 variable interest entities. The Board believes that if a business enterprise has a
14 controlling financial interest in a variable interest entity, the assets, liabilities,
15 and results of the activities of the variable interest entity should be included in
16 consolidated financial statements with those of the business enterprise.

17
18 FIN 46 (R) goes on to explain the difference between the accounting that will occur
19 under this interpretation and current practice as follows—

20 Under current practice, two enterprises generally have been included in
21 consolidated financial statements because one enterprise controls the other
22 through voting interests. This Interpretation explains how to identify variable
23 interest entities and how an enterprise assesses its interests in a variable
24 interest entity to decide whether to consolidate that entity. This Interpretation
25 requires existing unconsolidated variable interest entities to be consolidated
26 by their primary beneficiaries if the entities do not effectively disperse risks
27 among parties involved. Variable interest entities that effectively disperse
28 risks will not be consolidated unless a single party holds an interest or
29 combination of interests that effectively recombines risks that were previously
30 dispersed.

31
32 An enterprise that consolidates a variable interest entity is the primary
33 beneficiary of the variable interest entity. The primary beneficiary of a
34 variable interest entity is the party that absorbs a majority of the entity’s
35 expected losses, receives a majority of its expected residual returns, or both,
36 as a result of holding variable interests, which are the ownership, contractual,
37 or other pecuniary interests in an entity that change with changes in the fair
38 value of the entity’s net assets excluding variable interests. An enterprise with
39 a variable interest in a variable interest entity must consider variable interests
40 of related parties and de facto agents as its own in determining whether it is
41 the primary beneficiary of the entity.

1
2 Assets, liabilities, and noncontrolling interests of newly consolidated variable
3 interest entities generally will be initially measured at their fair values except
4 for assets and liabilities transferred to a variable interest entity by its primary
5 beneficiary, which will continue to be measured as if they had not been
6 transferred. However, assets, liabilities, and noncontrolling interests of newly
7 consolidated variable interest entities that are under common control with the
8 primary beneficiary are measured at the amounts at which they are carried in
9 the consolidated financial statements of the enterprise that controls them (or
10 would be carried if the controlling entity prepared financial statements) at the
11 date the enterprise becomes the primary beneficiary. Goodwill is recognized
12 only if the variable interest entity is a business as defined in this
13 Interpretation. Otherwise, the reporting enterprise will report an extraordinary
14 loss for that amount. After initial measurement, the assets, liabilities, and
15 noncontrolling interests of a consolidated variable interest entity will be
16 accounted for as if the entity was consolidated based on voting interests. In
17 some circumstances, earnings of the variable interest entity attributed to the
18 primary beneficiary arise from sources other than investments in equity of the
19 entity.
20

21 An enterprise that holds significant variable interests in a variable interest
22 entity but is not the primary beneficiary is required to disclose (1) the nature,
23 purpose, size, and activities of the variable interest entity, (2) its exposure to
24 loss as a result of the variable interest holder's involvement with the entity,
25 and (3) the nature of its involvement with the entity and date when the
26 involvement began. The primary beneficiary of a variable interest entity is
27 required to disclose (a) the nature, purpose, size, and activities of the variable
28 interest entity, (b) the carrying amount and classification of consolidated
29 assets that are collateral for the variable interest entity's obligations, and (c)
30 any lack of recourse by creditors (or beneficial interest holders) of a
31 consolidated variable interest entity to the general credit of the primary
32 beneficiary.
33

34 **Q How has FIN 46 (R) evolved in practice?**

35 **A** The calculations for FIN 46 (R) purposes are very detailed and are heavily
36 dependent on the cash flows of the contract and who bears ultimate responsibility for
37 residual gains and residual losses. This determination will be made when the Mesaba 1
38 PPA has been finalized and a thorough cash flow model has been developed. It is
39 premature now to determine if FIN 46 (R) would be applicable to the Mesaba 1 PPA,

1 but once a final PPA is agreed to, that determination will have to be made. A single
2 asset lessee situation, such as contained in the Mesaba 1 PPA and other PPAs that NSP
3 has entered into will be looked at carefully in a FIN 46 (R) context. It should be noted
4 that FIN 46 (R) is meant to be applied retroactively and pre-existing contractual
5 arrangements were supposed to be re-examined and subjected to the FIN 46 (R) tests.

6 **Q Has NSP consolidated any of its PPAs under FIN 46 (R)?**

7 A It does not appear that they have done so. Presumably, they have subjected their
8 existing PPAs to the requirements of FIN 46 (R) and concluded that they did not meet
9 the criteria for consolidating those PPAs. If those other PPAs could be structured to
10 avoid consolidation accounting under FIN 46 (R), the Mesaba 1 PPA could be
11 structured to avoid a requirement for NSP to consolidate it.

12 **Q Please discuss the lease accounting requirements of EITF 01-08.**

13 A EITF 01-08 started off as a project to re-examine EITF 98-10, Accounting for
14 Contracts Involved in Energy Trading and Risk Management Activities (“EITF 98-10”)
15 which was a transition standard dealing with energy trading contracts and how they
16 should be accounted for prior to the effective date of FAS 133, Accounting for
17 Derivative Instruments and Hedging Activities.

18 As part of the deliberations in getting to a consensus on EITF 01-08, it was
19 determined that certain energy contracts (and other contracts that had similar
20 characteristics) may be leases and should be accounted for as such. Contracts that fall in
21 to this category are transportation contracts, take-or-pay contracts, tolling arrangements
22 and single asset lessee contracts (i.e., power purchase contracts). EITF 01-08 did not
23 presuppose that all of these types of agreements are leases, but that they contain

1 attributes of leases that should be evaluated against the lease criteria contained in
2 FAS 13.

3 EITF 01-08 discusses the criteria to consider in determining whether a PPA is a
4 lease. Once that determination is made, the contract is further evaluated against the
5 lease criteria in FAS 13.

6 **Q Was the Mesaba 1 PPA based on the NSP Model Dispatchable Power Purchase**
7 **Agreement?**

8 A Yes it was and it was intended to meet all of the specifications relevant to
9 accounting treatment that the NSP Model PPA requires. Further, based on similar
10 testimony that Mr. McDaniel provided in a Public Utility Commission of Colorado
11 (“Colorado PUC”) docket concerning power procurement bidding procedures, he was
12 concerned that the Colorado PUC ensure that they consider the accounting ramifications
13 of prospective PPAs to ensure that they would not have to be consolidated by the NSP
14 Colorado affiliate, Public Service Company of Colorado as part of its bid evaluation
15 process for new generating resources.

16 I reviewed the public version of a recent Calpine PPA that was negotiated with
17 NSP and noted that it generally followed the NSP Model PPA. My understanding is that
18 the Calpine PPA has not been consolidated under FIN 46 (R), did not qualify as a
19 capital lease under EITF 01-08 and FAS 13 and that it is subject to normal purchase /
20 normal sale accounting under FAS 133 (discussed in more detail below).

1 **Q Do you believe that the Mesaba 1 PPA and the Calpine PPA are similar in**
2 **structure and should be afforded the same accounting treatment?**

3 A My reading of the Calpine and Mesaba 1 PPAs indicate that they are very
4 similar in structure, both from a financial and operational standpoint. I have not been
5 privy to all of the details of the Calpine PPA nor have I reviewed any accounting
6 working papers prepared by NSP documenting the accounting review of the Calpine
7 PPA. Having been personally involved in several leasing transactions, I know that the
8 specific details of each transaction are critical in making a determination of what
9 accounting standard is applicable in each specific circumstance and that minor changes
10 in lease form, terms or economics can have a significant impact on the ultimate
11 accounting used to record the transaction.

12 Based on my review, I believe that if a standard similar to the standard that was
13 used to evaluate the Calpine PPA was applied to the Mesaba 1 PPA that it would be
14 possible to modify the Mesaba 1 PPA, if necessary, to ensure that it was not accounted
15 for as a lease transaction in the NSP financial statements.

16 **Q Mr. McDaniel is concerned about the possible effects of FAS 133 if it were applied**
17 **to the Mesaba 1 PPA. Do you have an opinion on the applicability of FAS 133 to**
18 **the Mesaba 1 PPA and if so, please provide that opinion?**

19 A FAS 133 is an enormously complex and inclusive accounting standard and it has
20 had significant effects on utility companies. If a power purchase or sale is not
21 considered a normal purchase / normal sale, then that transaction must be marked-to-
22 market with the fluctuations in value either being recorded in other comprehensive

1 income (on the balance sheet) or in current period net income. It is this variability that
2 Mr. McDaniel refers to in his testimony.

3 Mr. McDaniel believes that the terms of the Mesaba 1 PPA are such that if
4 electricity purchased under this PPA would not qualify for normal purchase / normal
5 sale treatment, there could be significant fair market value changes in the contract value
6 that would have to be accounted for by NSP. That is a true statement. While he sets
7 forth the requirements that must be met, he doesn't explain why the Mesaba 1 PPA may
8 not qualify for normal purchase / normal sale treatment. The terms of the Calpine PPA
9 seem similar to the terms of the Mesaba 1 PPA with regard to the factors that one would
10 evaluate in making a determination if the electricity purchased under that contract
11 qualified for the normal purchase / normal sale exception. Based on the fact that the
12 Calpine PPA appears to qualify for the FAS 133 normal purchase / normal sale
13 exception, I would expect that the Mesaba 1 PPA would also qualify for that exception.

14 Further, my experience is that bi-lateral contracts similar to the Calpine and
15 Mesaba 1 PPAs generally qualify for the normal sale / normal purchase exceptions. In
16 addition, if the Mesaba 1 PPA qualifies as an operating lease under FAS 13 (which
17 means that it would not be capitalized by NSP), it would not be subject to FAS 133
18 since leases are specifically exempted from FAS 133 (see paragraph 5 of EITF 01-08).

19 **Q Have you found other examples of power purchase agreements that have been**
20 **capitalized in the financial statements of utility companies under either FIN 46 (R)**
21 **or EITF 01-08?**

22 **A** Surprisingly, I have not. While an exhaustive search was not conducted, only
23 one example of a PPA being capitalized under EITF 01-08 was found and that PPA had

1 one significant difference from the transaction being considered here—the utility owned
2 the leased asset at the end of the lease term for no additional payments.

3 In general, the utility industry has, for the most part, been able to structure PPA
4 transactions in such a manner that those transactions did not have to be capitalized in
5 the financial statements of the utility taking the power. I believe that the Calpine PPA is
6 an example of being able to structure a transaction to avoid both capitalization in the
7 financial statements and treatment as a derivative subject to mark-to-mark accounting
8 (and hence potentially significant volatility).

9 IV. CONCLUSION

10 **Q What is your conclusion in this matter?**

11 A I believe that, if necessary, the Mesaba 1 PPA could be amended in a manner to
12 ensure that it would not be consolidated in accordance with the requirements of FIN 46
13 (R) nor would it be considered a capital lease on the financial statements of NSP.
14 Further, I believe that power taken by NSP under this PPA would qualify for the normal
15 purchase/normal sale exception contained in FAS 133.

16 NSP has successfully structured other PPA transactions such that they are not
17 capitalized and that experience could be brought to bear on this transaction to the
18 mutual benefit of both parties.

19 **Q Does this conclude your prepared rebuttal testimony?**

20 A Yes.

EXHIBIT NO. ____ (MJH-1)

Statement of Qualifications

Michael J. Hamilton

Position

Senior Managing Director at FTI Consulting

Education

B.S., Accounting, St. Francis College

Overview of Experience

Mr. Hamilton is a senior managing director at FTI Consulting, specializing in the energy industry, where he has been since he retired from PricewaterhouseCoopers LLP in February 2003. He had extensive audit experience while at PricewaterhouseCoopers LLP where he was either the audit partner or concurring partner on a substantial portion of that Firm's energy-related audit clients. In addition, he has been involved in virtually all of the utility restructuring and bankruptcy situations since 1989. He has served as the financial advisor to numerous interest groups where he brings his knowledge of both utility finance and his restructuring skills to maximize the recovery for his clients. In this regard, his activities include due diligence, sophisticated computer modeling, creditor committee management and transaction negotiation.

Mr. Hamilton has been continuously involved in regulated industry-related activities since 1972. He has worked with numerous regulated industry companies, including companies in the electric, gas, water and telecommunications industries. He has been substantively involved in issues related to the competitiveness of the electric utility industry as it fundamentally restructures from a monopoly position to a competitive position. His activities include a wide range of advisory, special studies, rate-making, tax and testimony activities. He has also spent seven and one-half years at an investor-owned electric utility where he was responsible for the day-to-day operations in virtually all of its the financial operations.

Relevant Experience

Audit Related Experience

Mr. Hamilton was an experienced audit partner at PricewaterhouseCoopers LLP where he was responsible for that Firm's U. S. Utility Practice related to all audit and tax services. He was also the technical liaison between the audit practice and his Firm's Risk and Quality Group where he participated in the resolution of energy industry accounting issues and the development of his Firm's position with regard to responses to new accounting proposals.

Mr. Hamilton was the engagement partner on the audits of the American Water Works Company and each of the related system companies, CH Energy, Inc., Consolidated Edison, Inc., Elizabethtown Water Company, Illinova Corporation, The Los Angeles Department of Water and Power, P&L Resources, Inc.; Southern California Public Power Authority, The United Illuminating Company and a number of smaller energy-related companies.

Additionally, Mr. Hamilton was the concurring partner (a role where he participated in all substantive decisions regarding client accounting issues and also reviewed the quarterly and annual financial statements and attended audit committee meetings) on Allegheny Energy, California Independent System Operator, Dynegy, Inc., Edison International, Entergy Corporation, Long Island Power Authority, the National Grid domestic subsidiary companies, New York Power Authority, Northern States Power, PJM Interconnection, Ridgewood Energy Investment Partnerships, Portland General Electric and Unisource Energy.

Mr. Hamilton has significant experience in reviewing electric and gas trading operations both with respect to his audit clients, but also in restructuring and due diligence assignments. He was the energy industry liaison to the PricewaterhouseCoopers national office group that dealt with Statement of Financial Accounting Standards No. 133, *Accounting for Derivatives* (“FAS 133”) and the ongoing development of derivative accounting principles and interpretations thereof related to the application of FAS 133 to the utility industry. He also assisted clients in the development and implementation of practices and procedures related to the operation of front, middle and back office operations related to their trading operations.

He has worked with a number of clients on international investments, both in the purchase of foreign companies and individual foreign assets and is extremely familiar with the accounting and reporting requirements for international investments.

Merger and Acquisition Experience

Mr. Hamilton has assisted on the evaluation, due diligence and determination of the appropriate accounting treatment for a number of mergers and also in a number of situations where the merger was not consummated for one reason or another. He assisted in the development of synergy saving opportunities and has testified on a mechanism for tracking synergy savings before the Illinois Public Utility Commission. He has certified financial statements where synergy savings have been recorded.

He performed due diligence for the acquisition by a Public Utility Holding Company of a major investment bank’s electricity trading operations.

He also provided the transaction support for the sale and leaseback of \$500 million of generating facilities, which accounting was subsequently affirmed by the Securities and Exchange Commission

Energy Policy

Mr. Hamilton was an advisor to the Speaker of the California Assembly during the California energy crisis with regard to the analysis of energy legislation and the effects that that legislation would have on California's investor-owned and municipal electric utilities.

Restructuring and Bankruptcy

Mr. Hamilton is one of the nation's most experienced financial advisors with regard to energy industry restructurings and bankruptcies and has been involved in substantially all of the energy industry restructurings and bankruptcies, beginning with the Public Service Company of New Hampshire bankruptcy in the late 1980's.

Testimony Experience

Mr. Hamilton has testified frequently on various accounting and financial matters including testimony before the Federal Energy Regulatory Commission, the Securities and Exchange Commission, the Bankruptcy Court, the Financial Accounting Standards Board, the Railroad Accounting Standards Board and the state regulatory commissions in California, Illinois, Iowa, Maryland, Missouri, New Jersey and Texas. He has also been an expert witness in several lawsuits relating to independent power contracts, all of which have settled prior to trial.

Professional and Business Affiliations

Mr. Hamilton is a member of the American Institute of Certified Public Accountants and is a Certified Public Accountant in the District of Columbia and is licensed in a number of other states.