

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

MARGARET A. MEAL, CFA

OCTOBER 10, 2006

1 **EXCELSIOR ENERGY, INC.**

2 **BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION**

3 **PREPARED REBUTTAL TESTIMONY OF**

4 **MARGARET A. MEAL, CFA**

5 **Q Please state your name, current employment position and business address.**

6 A My name is Margaret A. Meal. I provide consulting services to participants in
7 the electric power industry, primarily financial and investment analysis. My business
8 address is 120 Jersey Street, San Francisco, California 94114.

9 **Q On whose behalf are you testifying?**

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

12 **Q Please describe your qualifications.**

13 A I have worked in the electric power industry for my entire professional career,
14 primarily as a consultant advising business interests, public agencies, investors, lenders
15 and regulatory agencies on financial and economic issues, including asset valuation,
16 risk assessment, financing alternatives, utility cost of capital and ratemaking. A
17 statement of my qualifications and experience is attached as Exhibit MAM-1.

18 Scope and Summary

19 **Q What is the purpose of your rebuttal testimony in this proceeding?**

20 A The purpose of my testimony is to address concerns raised by Northern States
21 Power (NSP) in the direct testimony of George E. Tyson II and John J. Reed regarding
22 the impact of the Mesaba 1 PPA on the credit quality and bond ratings of both NSP and
23 its parent company Xcel Energy Inc. (XEI). My testimony shows that NSP’s claims of

1 significant deterioration in credit quality, credit rating downgrades, substantial equity
2 investments and increased revenue requirements as the result of the Mesaba 1 PPA are
3 overstated and unreasonable.

4 **Q Please summarize your findings.**

5 Qualitatively, NSP's assessment of the likely credit quality impacts of the
6 Mesaba 1 project is incomplete. NSP considers only possible increases in financial risk
7 due to the Mesaba 1 PPA in isolation, and fails to consider reductions in risk exposure
8 for NSP and XEI that are provided by the baseload generation resource delivered under
9 that PPA. The Mesaba 1 project will interact with the broad range of risks currently
10 faced by NSP, both currently and prospectively, and will reduce some of those risks,
11 specifically construction spending and capacity shortfall risks. Any financial risk or
12 imputed debt that may be assigned by the rating agencies to the Mesaba 1 PPA is
13 largely a function of MPUC rulings regarding cost recovery and can be minimized.

14 Quantitatively, NSP's estimates of financial risk, as measured by estimates of
15 imputed debt that might be assigned by the rating agencies to Mesaba 1, are overstated
16 and unreasonable as well. The quantitative analysis relies solely on a formula that is
17 used by only one rating agency to measure one element of the overall impact of the
18 Mesaba 1 PPA on overall risk exposure, and in sole reliance on that formula, uses
19 unreasonable, "worst case" input assumptions, identifies numerous costs that would be
20 incurred but does not estimate these costs, assesses a very expensive remedy as a
21 possible solution, and describes down side scenarios of below investment grade credit
22 quality that would be, in fact, driven in large part by current construction spending
23 risks and by credit quality issues at NSP's parent company, XEI. Any estimates of

1 increased costs for NSP based on this quantitative analysis are similarly overstated and
2 unreasonable, including cost estimates of capital structure and equity ratio adjustments
3 to remedy or offset predicted reductions in credit quality. Correcting some of the errors
4 in the quantitative analysis shows that using reasonable assumptions, imputed debt
5 levels are not likely to result in financial measures significantly different from NSP's
6 and XEI's recent results, such that significant credit rating downgrades appear to be
7 unlikely.

8 **Q Does your testimony address NSP's claims that the Mesaba 1 PPA might require**
9 **financial consolidation or treatment as a capital lease, both under GAAP**
10 **accounting rules, and the resulting impact of such treatment on NSP's bond**
11 **ratings and credit quality?**

12 A No. As described in the testimony of Excelsior's witness Michael J. Hamilton,
13 to conclude that GAAP accounting rules will result in financial consolidation or
14 treatment as a capital lease is both speculative and premature.

15 **Q Please describe how your testimony is organized.**

16 Section 1 of my testimony shows that the rating agencies that rate NSP's and
17 XEI's bonds identify numerous risks that put downward pressure on NSP's and XEI's
18 bond ratings and credit quality, so that any assessment of the credit quality impact of
19 the Mesaba 1 project needs to consider whether any of those risks are avoided or
20 reduced, together with whether any risks may be increased. Section 1 is further divided
21 into subsections as follows:

22 A. Risks for NSP as identified by the rating agencies

23 B. Construction Spending Risks, and Impact of the Mesaba 1 PPA

1 C. Regulatory Risks

2 D. PPA Financial Risk and Likely Applicability to the Mesaba 1 PPA

3 E. Conclusions

4 Section 2 addresses NSP's quantitative analysis and shows that Mr. Tyson's
5 estimates of imputed debt and resulting impact on credit metrics and in turn bond
6 ratings are unrealistic and overstated.

7 Section 3 describes the problems with NSP's estimates of costs that would be
8 incurred as the result of downgrades, possible remedies, and in particular, the dire
9 circumstances predicted should any bond rating of NSP or XEI fall below investment
10 grade.

11 Section 4 provides a summary of my conclusions and my recommendations.

12 Section 1.

13 Qualitative assessment of NSP's primary risks, risk exposure and credit quality,

14 and changes in risk exposure with the Mesaba 1 project

15 **Q Why is it important to identify and recognize all of the primary risks that impact**
16 **NSP's credit quality in an assessment of the credit quality impacts of the Mesaba**
17 **1 PPA?**

18 **A** Identifying and recognizing these risks is important because to the extent that
19 the Mesaba 1 project reduces any of NSP's existing risks, those reductions need to be
20 included the assessment.

1 **Q How can the potential for risk reductions be included in an evaluation of the**
2 **impact of the Mesaba 1 project on NSP's credit quality?**

3 A The potential for risk reductions can be included by considering not only any
4 financial risk that might be assigned to the Mesaba 1 PPA, but by also including risk
5 reductions that result from the base load generating capacity that is provided. The two
6 pieces go together: when NSP executes the Mesaba 1 PPA, it also gets a commitment
7 to deliver power. Such an assessment needs to incorporate both qualitative and
8 quantitative factors where appropriate.

9 A. Risks for NSP as identified by the rating agencies

10 **Q Which rating agencies rate NSP and XEI bonds?**

11 A Three nationally-recognized rating agencies rate NSP's and XEI's bonds:
12 Standard and Poor's (S&P), Moody's Investors Service (Moody's), and Fitch Ratings
13 (Fitch). Each of these rating agencies also publishes reports that summarize qualitative
14 and quantitative factors that are used to develop the bond ratings that are assigned.

15 **Q Is it important to consider bond ratings as published by all three rating agencies**
16 **in this proceeding?**

17 A Yes. First, a bond rating is useful as an indicator of a utility's credit quality,
18 because it provides a rating agency's assessment of risks taken by bond holders. Bond
19 ratings, and more generally the rating agencies' assessments of risk exposure and credit
20 quality, are based on subjective and qualitative elements, as well as objective and
21 quantitative elements. The rating agencies use different methodologies and assign
22 different weights to various factors that determine ratings. In some cases (and in the
23 case of both NSP and XEI), resulting bond ratings from the three rating agencies are

1 different. Second, bond ratings and reports from all three agencies are recognized and
 2 used by the financial markets as indicators of risk and credit quality. Third, market
 3 prices of bonds with the same rating and maturity can vary, indicating that the broad
 4 market’s perception of risk and credit quality can vary from a rating agency’s
 5 assessment. As a result, no single rating can be considered as the definitive indicator or
 6 measure of the risk profile and credit quality of a company.

7 **Q What are NSP’s and XEI’s current bond ratings?**

8 A NSP’s and XEI’s current bond ratings are shown in the table below and
 9 graphically in Exhibit MAM-2. Notably, with the single exception of S&P’s rating on
 10 NSP’s senior unsecured debt, NSP’s bond ratings are at least 4 notches above non-
 11 investment grade (BB+) levels. All of NSP and XEI’s bond ratings are assigned
 12 “stable” outlooks, meaning that the rating agencies do not foresee changing any of
 13 these ratings in the near to mid term. For example, S&P’s “outlook” time frame is two
 14 years.¹

15 Current Bond Ratings and Outlook, NSP and XEI

	S&P		Moody’s (S&P equiv.)		Fitch	
	Bond Rating	Notches over BB+	Bond Rating	Notches over BB+	Bond Rating	Notches over BB+
NSP Senior secured	A-	4	A	5	A+	6
NSP Senior unsecured	BBB-	1	A-	4	A	5
XEI Senior unsecured	BBB-	1	BBB+	3	BBB+	3
Outlook (NSP and XEI)	Stable		Stable		Stable	

16
¹ Standard and Poor’s, “Corporate Ratings Criteria 2006,” p. 14, available on S&P’s website.

1 **Q Can you explain why S&P’s BBB- rating for NSP’s senior unsecured bonds is so**
2 **different from NSP’s other bond ratings, including S&P’s senior secured bond**
3 **rating?**

4 A Not precisely. However, in its April 2006 report on NSP, S&P clarifies that (i)
5 “The ratings on Northern States Power Co. (NSP-Minnesota) are based on the
6 consolidated credit profile of Xcel Energy Inc.,”² indicating that S&P’s senior
7 unsecured bond rating for NSP is directly linked to S&P’s credit rating for XEI on a
8 consolidated basis. In contrast, S&P’s senior secured bond rating for NSP is tied more
9 closely to the credit strength of NSP itself, as S&P puts NSP’s senior secured rating
10 three notches higher than NSP’s senior unsecured rating, based on the amount of
11 collateral at NSP itself that secures that debt.³

12 **Q Do Fitch and Moody’s base NSP’s bond ratings on the bond ratings or credit**
13 **quality of XEI?**

14 A Not directly. Based on my review of the rating agencies’ reports as described
15 further below, only S&P describes a direct linkage between NSP and XEI’s bond
16 ratings and highlights the debt burden of XEI as a significant risk factor for NSP.

17 **Q What are the primary factors considered by these three rating agencies in**
18 **assigning utility bond ratings and assessing utility credit quality?**

19 A Broadly, bond ratings are determined based on a rating agency’s assessment of
20 numerous qualitative and quantitative factors, based on a review of the company, its
21 market, management and financial structure, identification of demand, supply,
22 construction, operating, commodity price, environmental, regulatory and other risks,

² Standard and Poor’s, Northern States Power Co., April 20, 2006.

³ Standard and Poor’s, Northern States Power Co., April 20, 2006.

1 and identification of risk mitigation measures, credit support and other positive factors
2 that may offset these risks. The overall rating is based on qualitative factors combined
3 with quantitative analysis that measures various financial ratios to allow for
4 comparisons across companies.

5 **Q In recent rating agency reports, what specific major credit quality concerns have**
6 **the rating agencies identified for NSP?**

7 A Based on my review of recent reports published by the rating agencies, all three
8 rating agencies identify several risks faced by NSP; some are faced by utilities
9 generally, some are specific to NSP or heightened for NSP due to its particular
10 circumstances. Notably, all three rating agencies identify different sets of risks for
11 NSP. The range of risks identified in the agencies' recent reports is summarized in
12 Exhibit MAM-3. Common in the text of all three reports are two significant risks for
13 NSP:

- 14 • Large construction spending requirements
- 15 • Adverse regulatory rulings regarding cost recovery

16 Rating agency summaries of specific factors that could lead to a down grade
17 and any identification of primary credit weaknesses also provide a useful summary of
18 some of the rating agencies' major concerns; these are summarized for NSP in the table
19 below.

1 Factors most likely to result in downgrade and major weaknesses identified
 2 in recent rating agency reports -- NSP

S&P	Moody's	Fitch
<ul style="list-style-type: none"> • adverse or less supportive regulatory rulings • Xcel consolidated debt burden (identified as sole weakness) 	<ul style="list-style-type: none"> • adverse or less supportive regulatory rulings • higher capital spending • increased debt leverage • operating problems 	<ul style="list-style-type: none"> • adverse or less supportive regulatory rulings • cost overruns on construction • increased debt leverage

3
 4 Additionally, S&P specifically identifies high levels of debt leverage of the
 5 consolidated XEI as a credit concern, stating that the only NSP rating factor weakness
 6 is that “parent company’s debt increases utilities’ debt service burden.”⁴

7 **Q Why would high levels of debt at NSP’s parent company impact the NSP rating?**

8 A To the extent that a rating agency bases its bond ratings for a utility on the
 9 consolidated credit profile of its parent company, as S&P does for NSP, any credit
 10 issues for the parent that are separate from the utility would put downward pressure on
 11 the utility’s bond ratings. In this case, S&P has identified XEI’s high level of debt as
 12 one of these credit issues, has identified it as a concern, and therefore it is a
 13 contributing factor in S&P’s bond ratings for NSP.

14 **Q Given that debt levels at XEI are a contributing factor in S&P’s bond ratings for**
 15 **NSP, how can their impact be isolated or subtracted out from an assessment of**
 16 **NSP’s credit quality?**

17 A Isolating or subtracting out the impact of specific credit issues on bond ratings
 18 and credit quality is difficult and would require both quantitative and qualitative
 19 adjustments. In this case, however, given the clear disparity between S&P’s senior
 20 unsecured bond rating and all of NSP’s other bond ratings, and S&P’s specific

⁴ Standard and Poor’s, Northern States Power Co., April 20, 2006.

1 identification of XEI debt levels as a contributing factor in that rating, to assess NSP's
2 credit quality absent the impact of debt levels at XEI, I would assign less weight to
3 S&P's senior unsecured bond ratings and would put more weight on NSP's other bond
4 ratings. In fact, it appears that the market itself assigns less weight to S&P's bond
5 ratings for NSP. For example, in Mr. Tyson's direct testimony in NSP's recent rate
6 case, he stated that he believes "the pricing of the Company's recent debt issuance is
7 more in line with the Moody's ratings."⁵

8 B. Construction spending risks, and impact of the Mesaba 1 PPA

9 **Q Please elaborate on the rating agencies' concerns regarding NSP's current capital**
10 **spending requirements.**

11 A All three rating agencies identify NSP's and XEI's needs for construction
12 spending as a significant risk. NSP's and XEI's planned construction programs clearly
13 put downward pressure on NSP's ratings and upward pressure on NSP's cost of capital.

14 Examples of rating agency comments on NSP's and XEI's construction plans
15 include:

16 S&P: "Xcel, like other utilities in the region, must increase spending for new
17 plant construction and environmental upgrades to meet increased
18 electricity demand and increasingly stringent air quality requirements."⁶

19
20 Moody's: Under 'Credit Challenges:' "Over the next several years, Xcel's capital
21 expenditures will be substantial" and "large and increasing capital
22 expenditure programs at the utilities over the next several years will
23 limit free cash flow."⁷

24
25 Fitch: "The new rating also takes into consider [sic] potential credit concerns
26 for XEL's increased level of utility capital expenditures over the next

⁵ Direct Testimony of George E. Tyson II, Docket No. E002/GR-05-1428, November 2, 2005.

⁶ Standard and Poor's, Northern States Power Co., April 20, 2006.

⁷ Moody's Investors Service, Analysis, Xcel Energy Inc., June 2005.

1 several years, with attendant risks of cost overruns or difficulties in
2 getting timely regulatory orders.”⁸

3 “Primary rating concerns are an unfavorable outcome in NSPM’s
4 upcoming electric base rate case filing or cost overruns of the MERP
5 project.”⁹

6 “Rating concerns relate to the risks of unfavorable rate decisions and
7 cost overruns on specific projects.”¹⁰

8
9 **Q What other evidence do you have regarding NSP’s capital spending plans?**

10 **A** Both NSP and XEI’s planned capital spending programs are large. As noted by
11 Fitch in 2005, XEI “estimates that it will spend **6.9 billion** on utility assets [2005]
12 through 2009.”¹¹ This amount covers core capital spending, the Minnesota Emissions
13 Reduction Project (MERP) and Public Service Company of Colorado’s (PSCo’s)
14 Comanche 3 project, and planned spending on these programs alone over just five
15 years amounts to nearly 50% of \$14.1 billion in net property, plant and equipment
16 assets held by XEI at the end of 2004.¹²

17 Roughly \$3.3 billion of this spending (nearly 50% of the total) is planned for
18 NSP, and will push NSP’s capital programs well above historical levels. As shown in
19 the chart below (with details included in Exhibit MAM-4), NSP’s capital spending
20 from 2005-2009 will be, on average, 54% higher than it was from 2000-2004.

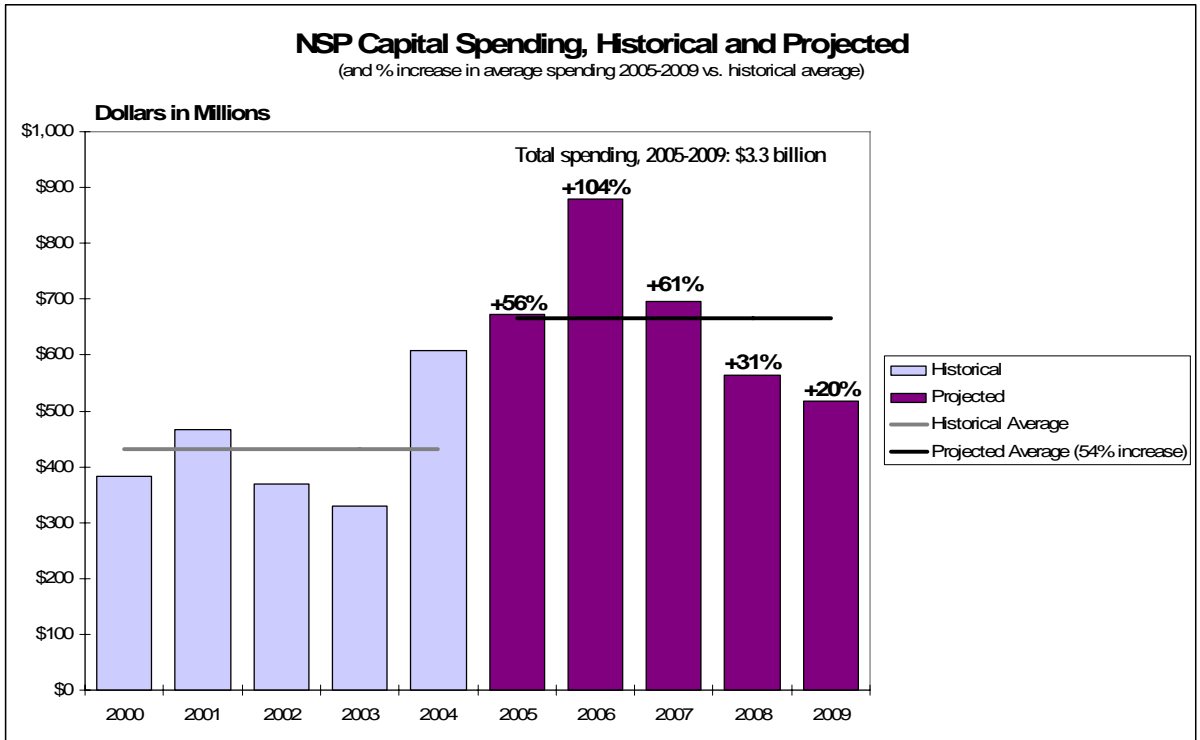
⁸ Fitch Ratings, Fitch Ratings Upgrades Xcel Energy to BBB+, Outlook Stable, August 9, 2005.

⁹ Fitch Ratings, Fitch Ratings Upgrades Xcel Energy to BBB+, Outlook Stable, August 9, 2005.

¹⁰ Fitch Ratings, Xcel Energy Inc., September 8, 2005.

¹¹ Fitch Ratings, Xcel Energy Inc., September 8, 2005. (emphasis added)

¹² Xcel Energy Inc. 10k 2005.



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10 **Q How does NSP intend to fund its existing capital spending requirements?**

11 A For the most part, NSP intends to fund its spending programs with internally
 12 generated funds. XEI's 2005 10k states, "Xcel Energy generally expects to fund its

1 operations and capital investments through internally generated funds.”¹³ In a
2 November 2005 presentation to investors on its financial plan, XEI concluded that its
3 “capital expenditure program can be financed with only DRIP [dividend reinvestment
4 program] and modest debt offerings.”¹⁴ To the extent this is achievable, NSP avoids the
5 risk and need to access the capital markets to fund this spending.

6 **Q Are internally generated funds likely to be sufficient to fund NSP’s existing**
7 **capital spending requirements?**

8 A Possibly, but there is essentially no cushion to fund any additional capital
9 spending, and recent additions to the capital spending plan would likely require outside
10 funding sources. This conclusion is based on XEI information included in several slide
11 presentations to investors in 2005 and 2006, with relevant slides excerpted in Exhibit
12 MAM-5. As shown in that Exhibit, in November 2005, XEI presented a financing plan
13 only just sufficient to cover \$5.7 billion in capital spending over four years (2006-
14 2009) without significant new financing. That plan showed a net issuance of XEI
15 consolidated debt of \$400 million over the period. However, that plan covers only
16 “base level” capital expenditures, MERP and Comanche 3. More recently (as of
17 September 2006), XEI has added to that “investment pipeline,” forecasting significant
18 additional capital expenditures, including:

- 19 • \$700 million, CapX 2020, 2009-2012
- 20 • \$ 4 million, Colorado IGCC, 2007-2009, with additional amounts thereafter
- 21 • \$30 million, Mercury, 2007-2011, with additional amounts thereafter

¹³ Xcel Energy Inc. 2005 10k, p. 81.

¹⁴ Xcel Energy, Inc. slide presentation, Executing the Financial Plan, New York Investor Meetings, November 29, 2005.

1 **Q What do you conclude regarding NSP’s risk exposure regarding its capital**
2 **spending plans and requirements?**

3 A NSP’s and XEI’s current spending plans, which exclude any expenditures for
4 new base load generating capacity to serve NSP, are large, higher than historical levels,
5 and at the limit of what can be funded through internally generated cash. This creates a
6 large risk exposure that is recognized by the rating agencies and puts downward
7 pressure on NSP’s bond ratings and cost of capital. Additional construction spending
8 will increase this pressure and result in a reduction in credit quality. Rating agencies
9 have recognized increasing construction spending risks as a credit issue for utilities
10 generally. For example, in January 2006, Fitch highlighted “higher capital spending
11 and other risks associated with new base-load construction cycle” and that “higher
12 capital spending will result in increased external funding needs” as key credit drivers
13 for utilities industry-wide over the next five years.¹⁸

14 **Q In your view, could NSP make the investment required to support capital**
15 **spending that would be required between now and 2011 to complete construction**
16 **of a base load plant by 2011?**

17 A As shown above, the capital spending required to complete construction of a
18 base load plant by 2011 would add to NSP’s and XEI’s already full investment pipeline
19 between now and 2011, and would likely require issuances of new debt and/or equity
20 contributions from XEI. None of NSP’s current plans includes spending for a base load
21 plant to serve NSP’s customers. As a result, if NSP were to make the investment

¹⁸ Fitch Ratings, “U.S. Power and Gas 2006, Outlook for Key Credits,” January 11, 2006, p. 2

1 required for a new base load plant to be completed by 2011, issuance of new debt
2 and/or equity contributions from XEI would be required.

3 **Q Would NSP's credit quality suffer as a result?**

4 The additional capital spending requirement would likely have a negative
5 impact on NSP's credit quality. As described further below, to offset the negative
6 impact, NSP could, and would likely, request up-front regulatory approvals in advance
7 of this spending in an effort to reduce risks for NSP's bond holders and maintain NSP's
8 bond ratings.

9 **Q What will happen to NSP's construction spending risk, or any other risks, if the
10 Mesaba 1 PPA is not approved and the project does not go forward?**

11 A That depends on what NSP would substitute for the base load generating
12 capacity that is provided by the Mesaba 1 PPA. Without the Mesaba 1 PPA (or any
13 other PPA delivering base load generating capacity), NSP's options are to either (i)
14 build a base load generating resource itself, or (ii) do nothing to substitute for the base
15 load generating resource that is provided by the Mesaba 1 project. Both of these
16 options have risks.

17 **Q What are NSP's risks if it builds base load capacity as a substitute for the Mesaba
18 1 base load resource?**

19 A As described above, building capacity increases capital spending requirements,
20 and NSP/XEI's current spending plans in the construction time frame for Mesaba 1 are
21 large, significantly higher than NSP/XEI have undertaken in recent years, and at or
22 above levels supportable with internally generated funding sources. Undertaking
23 construction of a base load resource in this time frame (i) would require accessing the

1 capital markets for funding, (ii) would strain NSP/XEI's construction management
2 resources, and (iii) would necessarily expose NSP and/or its ratepayers to risks
3 regarding cost overruns, delays, and performance problems. Consistent with recent
4 construction projects, and because NSP/XEI's current construction program already
5 puts significant downward pressure on credit quality, NSP/XEI would likely seek
6 Commission approval to shift much of this risk to NSP's ratepayers, in an effort to
7 limit the adverse impact of construction spending on NSP's credit quality.

8 **Q What are NSP's risks if, alternatively, it does nothing to substitute for the Mesaba**
9 **1 base load resource?**

10 The "do nothing" option exposes NSP to risks as well. Under any resource
11 planning scenario, just as there are risks of over building, there are risks of under
12 building. NSP is always exposed to the risks of capacity shortfalls in the event that
13 demand exceeds supply. Further, since doing nothing is an alternative to a base load,
14 coal-fired resource, NSP is exposed to the risk of procuring replacement power based
15 on volatile and likely higher natural gas prices. As shown in the testimony of
16 Excelsior's witness Andrew Weissman regarding the size, type, and timing of new
17 generation needed in Minnesota and price volatility in the gas markets, the risks of the
18 "do nothing" alternative are significant and cannot be ignored.

19 In short, without the Mesaba 1 project (or any other project delivering a base
20 load resource under a PPA), risks associated with capital spending or capacity
21 shortfalls, including gas price volatility risks, will increase.

1 C. Regulatory Risks

2 **Q Please elaborate on the rating agencies' concerns regarding adverse regulatory**
3 **rulings.**

4 A All three rating agencies recognize and identify NSP's regulatory climate as
5 favorable and supportive of NSP's bond ratings. As such, each of the rating agencies
6 indicates that a *downturn*, or a *change to a less supportive regulatory climate*, could
7 put bond holders at risk and put downward pressure on NSP's ratings. For example,
8 S&P identifies "regulatory support" as a strength for NSP, and states that "Minnesota
9 utility regulation is generally supportive of the company's strong credit quality."¹⁹
10 Similarly, both Moody's and Fitch identify adverse regulatory rulings as factors that
11 could put downward pressure on NSP's bond ratings.

12 **Q Why do the rating agencies give such emphasis to regulatory climate?**

13 A Regulatory treatment determines rates and the extent to which costs are
14 recoverable from ratepayers. For a regulated utility generally, regulatory treatment is a
15 primary factor in determining the extent to which future earnings and cash flows,
16 which come from ratepayers, are likely to be sufficient to cover operating costs and
17 debt service. As a result, from a bond holder's perspective, a "more favorable"
18 regulatory climate is one where regulators provide greater certainty to bond holders
19 regarding full cost recovery from ratepayers through rates, thereby reducing bond
20 holder risks that rates will be insufficient to cover cost overruns (overruns in all cost
21 categories, including capital expenditures, fuel and purchased power costs, labor costs
22 and employee benefit costs, interest costs, etc.). All else equal, a risk-averse bond

¹⁹ Standard and Poor's, Northern States Power Co., April 20, 2006.

1 holder prefers regulatory treatment that allows full recovery of costs incurred from
2 ratepayers under a broad range of downside circumstances, ranging from adverse
3 market and weather fluctuations to poor corporate cost controls and poor management.
4 Similarly, bond holders prefer regulatory rulings that authorize lower debt ratios,
5 higher ROEs, and higher revenue requirements.

6 **Q What other evidence do you have regarding the impact of regulatory rulings on**
7 **NSP's and XEI's credit quality?**

8 A The rating agencies have made special mention of how non-traditional
9 regulatory rulings regarding capital spending for NSP's MERP project and PSCo's
10 Comanche 3 project have been supportive of NSP's, PSCo's, and XEI's credit quality
11 and bond ratings, reducing risks for bondholders. The rating agencies have reported
12 that absent this special regulatory treatment, XEI's aggressive capital spending plans
13 would have resulted in a reduction in credit quality. This could have resulted in bond
14 rating downgrades due to excessive capital spending and construction risk. Some
15 examples of rating agency comments include:

16 S&P: "Also highly supportive of credit quality was the commission's
17 approval for the timely recovery of the approximately \$1 billion
18 invested to reduce emissions from plants in the Minneapolis/St. Paul
19 metro area."²⁰

20
21 Moody's: "With significant capital expenditures projected over the next five years,
22 supportive regulatory treatment will be a key factor in maintaining
23 Xcel's financial strength. In an effort to reduce uncertainty and mitigate
24 risk, Xcel has pursued a strategy of obtaining commission approvals for
25 the recovery of costs associated with significant projects prior to
26 proceeding with the investment."²¹

²⁰ Standard and Poor's, Northern States Power Co., April 20, 2006. (emphasis added)

²¹ Moody's Investors Service, Analysis, Xcel Energy Inc., June 2005. (emphasis added)

1 Fitch: “Successful execution of XEL’s core utility strategy requires favorable
2 regulatory actions, including general rate increases and allowances for
3 cost recovery of specific capital projects”²²
4

5 Further, XEI has stated that its objective to obtain regulatory approvals up front
6 for its construction investments to reduce risk for bond holders and shareholders is a
7 key part of its ongoing “Building the Core” program, stating in its 2005 10k:

8 “Our strategy of Building the Core has three phases. The first phase is obtaining
9 legislative and regulatory support for our large investment initiatives prior to
10 making the investment. To avoid excessive risk for the company it is critical to
11 reduce regulatory uncertainty before making large capital investments. We
12 accomplished this for both the Metropolitan Emission Reduction Project
13 (MERP) in Minnesota and the Comanche 3 coal plant in Colorado.”²³
14

15 Just recently, XEI’s Chairman, President and CEO Richard Kelly reiterated this
16 strategy in particularly blunt terms when he was quoted as stating:

17 “You’ve got to get the regulatory approval up front. We have gone to the
18 regulators and the state legislative body and have it written in law that we’re
19 going recover our investment before we spend a dime. We’ve got about \$5
20 billion worth of projects that we’re going to recover before we actually start
21 spending the money.”²⁴
22

23 **Q What is the consequence for ratepayers of up front regulatory approvals for**
24 **construction spending?**

25 **A** Up front regulatory approvals for construction spending shift risks from bond
26 holders and shareholders to ratepayers by reducing the risks to bond holder and
27 shareholders of cost recovery disallowances resulting from future prudency reviews.
28 For example, for NSP’s MERP project and for PSCo’s Comanche 3 project, ratepayers
29 will begin paying currently for large capital projects that will not actually be in-service
30 for several years. In turn, this increases revenue requirements, ROE and earnings per

²² Fitch Ratings, Xcel Energy Inc. Credit Analysis, September 8, 2005. (emphasis added)

²³ Xcel Energy Inc., 2005 10k, p. 53

²⁴ Martin Rosenberg, “Massive Build Ahead, an Executive Summit,” *EnergyBiz Magazine*, September/October 2006, p. 22

1 share during the construction period over and above levels allowed under traditional
2 ratemaking. Further, to the extent that the utility is unable to manage project
3 development, construction and operating risks, ratepayers will bear some or all of the
4 resulting costs and/or be faced with rate increases to support utility credit quality.

5 **Q How is the Commission's approval of the Mesaba I PPA different from the**
6 **perspective of ratepayers?**

7 A The Mesaba 1 PPA provides a base load resource while including contract
8 terms that shift significant risks of raising capital, developing, constructing, and
9 operating that resource away from NSP and its ratepayers, and in so doing, assures that
10 to the extent imprudent costs for the development, construction and operation of the
11 Mesaba 1 PPA are incurred, neither NSP nor its ratepayers will bear those costs. The
12 testimony of Excelsior's witnesses Thomas L. Osteraas and Edward C. Bodmer
13 demonstrates that the Mesaba 1 PPA includes these risk-shifting mechanisms and that
14 PPA payments will not include imprudently incurred costs.

15 **Q What do you conclude regarding NSP's risk exposure regarding adverse**
16 **regulatory rulings?**

17 A Both the rating agencies and NSP/XEI recognize that recent legislative and
18 regulatory treatment has supported NSP and XEI's credit quality and bond ratings, by
19 reducing risks for bond holders associated with NSP's and XEI's large capital spending
20 programs. NSP and XEI have embarked on these aggressive spending programs with,
21 to date, no change in their bond ratings. Given the magnitude of NSP and XEI's current
22 construction spending plans, any further capital spending is likely to (i) require going
23 to the capital markets to raise cash from external funds, (ii) significantly weaken credit

1 quality, putting downside pressure on bond ratings, and/or (iii) require similar
2 regulatory treatment to support credit quality.

3
4 D. PPA Financial Risk and Likely Applicability to the Mesaba 1 PPA

5 **Q You did not identify NSP's existing PPAs as a significant factor for NSP. Why**
6 **not?**

7 A NSP's existing PPAs are not identified as a significant risk factor in any of the
8 three rating agencies' recent reports on NSP.

9 **Q How do the rating agencies assess PPA risk?**

10 A Exhibit MAM-6 summarizes my review of the rating agencies' publications
11 regarding financial risks of PPAs generally and their methodologies for rating electric
12 utilities generally. This Exhibit also shows how the rating agencies treat NSP's existing
13 PPAs, based on their recent reports for NSP.

14 Each rating agency's approach to assessing PPA risk is somewhat different, but
15 several key elements are common to all three. All three consider both qualitative and
16 quantitative factors. All three recognize that the extent of PPA risk is utility and
17 contract specific. All three recognize that PPAs can have benefits that reduce risk for
18 bond holders, shareholders and ratepayers. All three rating agencies' criteria allow for
19 making quantitative adjustments to financial statements to account for financial risk of
20 PPAs if it is found to exist. All three agree that depending on the terms of the contracts
21 and regulatory treatment regarding recovery of PPA costs through rates, it may be
22 appropriate to calculate "imputed debt" and adjust financial statements and resulting
23 credit metrics for that imputed debt.

1 However, the rating agencies use different approaches to determine what levels
2 of imputed debt, if any, are appropriate, and, for example, have reached different
3 conclusions regarding appropriate levels of imputed debt for NSP's existing PPAs.

4 **Q What degree of financial risk, as measured by imputed debt, has been assigned by**
5 **the rating agencies to NSP's existing PPAs?**

6 A As described further below, the rating agencies' estimates of imputed debt and
7 PPA risk for NSP for 2005 fall within a range, specifically, from zero to \$401 million.
8 S&P's estimate (\$401 million²⁵) is at the high end of the range and is not representative
9 of the three rating agencies' assessments taken together. Moody's appears to assign
10 very little or limited risk, and very little or limited imputed debt, to NSP's PPAs, and
11 Fitch states that financial risk for NSP (as measured by imputed debt) is zero.

12 **Q Please describe how Moody's assesses PPA risk.**

13 A Moody's published criteria²⁶ are both qualitative and quantitative. Moody's
14 criteria allow for cases where PPAs result in financial risk and imputed debt
15 adjustments are appropriate, but any adjustments are contract and utility specific.
16 Moody's states that "PPAs have a wide variety of financial and regulatory
17 characteristics and are [sic] thus each particular circumstance may be treated
18 differently by Moody's." Moody's goes on to state that PPA risk is measured along a
19 "continuum", where at one end PPAs are considered as an operating cost and at the
20 other end PPAs are treated as a debt obligation. Several qualitative factors are
21 considered in determining where PPAs fall on that continuum:

²⁵ As shown in Direct Testimony of George E. Tyson II, Exhibit GET-1, Schedule 5, p. 1

²⁶ Moody's Investors Service, Rating Methodology: Global Regulated Electric Utilities, March 2005 (hereinafter Moody's Global Electric Utilities). .

- 1 • Risk management
- 2 • Pass-through capability
- 3 • Price considerations
- 4 • Excess reserve capacity
- 5 • Risk sharing
- 6 • Default provisions

7 In circumstances where regulators allow for recovery of contract costs in rates,
8 Moody's assigns no financial risk or debt equivalence, stating:

9 "Some utilities have the ability to pass through the cost of purchasing power
10 under PPAs to their customers. As a result, the utility takes no risk that the cost
11 of power is greater than the retail price it will receive. Accordingly Moody's
12 regards these PPA obligations as operating costs with **no** long-term debt-like
13 attributes."²⁷

14
15 Further, Moody's further describes situations where it views PPA payments as
16 similar to an operating cost, with no imputed debt adjustment, as follows:

17 "If a utility enters into a PPA for the purpose of providing an assured supply
18 and there is *reasonable assurance that regulators will allow the costs to be*
19 recovered in regulated rates, Moody's may view the PPA as being most akin to
20 an operating cost."²⁸

21
22 Finally, Moody's criteria recognize the benefits of PPAs, stating that "an
23 overarching principle is that PPAs have been used by utilities as a risk management
24 tool and Moody's recognizes that this is the fundamental reason for their existence."²⁹

25 Moody's cites the following as positive risk reduction features of PPAs:³⁰

- 26 • To outsource operating risks to parties more skilled in power station operation

²⁷Moody's Global Electric Utilities. (emphasis added)

²⁸Moody's Global Electric Utilities. (emphasis added)

²⁹Moody's Global Electric Utilities. (emphasis added)

³⁰Moody's Global Electric Utilities. (emphasis added)

- 1 • To provide certainty of supply
- 2 • To reduce balance sheet debt
- 3 • To fix the cost of power

Q How does Moody's assess the risk of NSP's existing PPAs?

A Moody's reports on XEI and NSP have limited references to financial risks of PPAs as applied to NSP. However, based on Moody's published criteria regarding the financial risk of PPAs, it is likely that Moody's has assigned little or no financial risk to NSP's PPAs.

4 **Q Does NSP presently have the ability to pass through the costs of purchasing power**
5 **under PPAs to their customers?**

A My understanding is that the cost of NSP's purchased power is generally allowed to be passed through in rates, NSP's capacity payments under its PPAs have been passed through in rates historically, and the Commission has never disallowed recovery of any of NSP's PPA capacity payments.

6 **Q Please describe how Fitch assesses PPA risk.**

7 A In general, Fitch's methodology for assessing financial risks of PPAs is similar
8 to Moody's, and considers the competitive position, cost and need for power that is
9 being purchased. Certainty of cost recovery is a primary factor that substantially
10 reduces or eliminates PPA financial risk. In a 2005 presentation, Fitch described its
11 treatment of PPAs as follows:

- 12 • "Power purchase contracts are generally treated as an operating expense.
- 13 • On an exception basis, Fitch adjusts debt on the books of the buyer if:
 - 14 - Contract is for a long term, and

- 1 - Price is above market (relative to Fitch models), and
2 - The buyer has a low likelihood of recovery of the contract cost from
3 regulated utility customers or from contract counterparties.”³¹

4 Notably, Fitch has determined that there is no “debt equivalency” for XEI or
5 NSP’s bond holders as the result of any of XEI’s subsidiaries’ existing PPAs, and
6 therefore NSP’s existing PPAs create no incremental financial risk for NSP. In its most
7 recent Credit Analysis on XEI, including its ratings of NSP, Fitch clearly states:

8 “While XEL’s subsidiaries have \$6.5 billion in off-balance-sheet power
9 purchase agreement obligations, the capacity payments associated with these
10 agreements are mostly recoverable, and therefore, no debt equivalency is
11 assumed.”³²
12

Q How does S&P assess the risk of NSP’s existing PPAs?

13 A S&P’s assessment of risk, credit quality and bond ratings generally consider
14 two measures of risk: (i) business risk, and (ii) financial risk. Specifically, S&P states
15 that “the fundamental [rating] methodology encompasses two basic components—
16 business risk and financial risk—and their relationship.”³³ Business risk is based
17 primarily on S&P’s assessment of qualitative factors; financial risk is based primarily
18 on S&P’s assessment of a utility’s financial condition based on credit metrics. PPAs as
19 part of a utility’s resource portfolio impact both overall business risk and financial risk.

20 In terms of financial risk, S&P views long-term PPAs with fixed capacity
21 payments as creating a financial obligation for the purchasing utility which can have
22 debt-like attributes under certain circumstances. Based on a qualitative assessment of

³¹ Fitch Ratings, Long Term Power Contracts: Credit Implications for Purchasers, Slide Presentation, October, 2005 (emphasis added)

³² Fitch Ratings, Xcel Energy Inc. September 8, 2005 (emphasis added)

³³ Standard and Poor’s, Assessing U.S. Vertically Integrated Utilities’ Business Risk Drivers, September 14, 2006.

1 contract terms, regulatory provisions regarding recovery of capacity payments in rates,
2 and other factors, S&P assigns a “risk factor” to the net present value of PPA capacity
3 payments to arrive at an imputed debt amount that is used to adjust a utility’s financial
4 statements for purposes of measuring financial ratios used by S&P as part of its bond
5 rating process. S&P’s methodology for determining risk factors and calculating
6 imputed debt have varied over the years. Its general approach for assessing PPA risk
7 overall has been in place since 1990, but the details of its actual methodology for
8 determining risk factors and calculating imputed debt has varied over this time period.

9 In terms of business risk, recently, S&P has cited several ways PPAs can reduce
10 business risk:

- 11 • “Buying power may be a more appropriate option for a utility than new plant
12 construction because the utility avoids construction costs and the financial
13 risks posed by regulatory lag when seeking recovery of costs.”
- 14 • “Purchasing power may enhance supply flexibility, fuel resource diversity,
15 and maximize load factors.”
- 16 • “Utilities that plan to meet demand projections with a portfolio of supply
17 side options also may be better able to adapt to future growth
18 uncertainties.”³⁴
- 19
- 20
- 21

22 In summary, although S&P does assign imputed debt to PPAs as a measure of
23 financial risk, S&P’s overall assessment of PPA risk goes beyond its estimates of
24 imputed debt and also considers positive impacts of PPAs on business risk.

25 **Q Please explain how S&P assigns a “risk factor” to PPA payments.**

26 **A** S&P’s determination of a risk factor is based primarily on its assessment of the
27 certainty of cost recovery of PPA payments in a utility’s rates. Recently, S&P

³⁴ Standard and Poor’s, Assessing U.S. Vertically Integrated Utilities’ Business Risk Drivers, September 14, 2006

1 described its approach for determining the risk factor as follows: “The risk factor is
2 largely a function of the strength of the regulatory recovery mechanisms established to
3 address procurement costs.”³⁵ In a 2003 report, S&P provided additional detail on its
4 determination of risk factors, with relevant sections excerpted below:

- 5 • “As a generic guideline for utilities with PPAs included as an operating
6 expense in base tariffs, Standard & Poor’s believes that a 50% risk factor is
7 appropriate for long-term commitments. This risk factor assumes adequate
8 regulatory treatment, including recognition of the PPA in tariffs; otherwise a
9 higher risk factor could be adopted to indicate a greater risk of recovery.”
- 10
- 11 • “For utilities in supportive regulatory jurisdictions with a precedent for
12 timely and full cost recovery of fuel and purchased power costs, a risk factor
13 of as low as 30% could be used.”
- 14
- 15 • “In certain cases, Standard & Poor’s may consider a lower risk factor of 10%
16 to 20% for distribution utilities where recovery of certain costs, including
17 stranded assets, has been legislated.”
- 18
- 19 • “It is unlikely that no portion of a PPA would be capitalized (zero risk
20 factor) under any circumstances.”³⁶
- 21

22
23 **Q What risk factor has S&P assigned to NSP’s PPAs?**

24 A Mr. Tyson’s testimony reports that S&P has assigned a risk factor of 30% to
25 NSP’s PPAs.³⁷ The risk factor of 30% indicates that S&P has determined that NSP is a
26 utility in a supportive regulatory jurisdiction with a precedent for timely and full cost
27 recovery of fuel and purchased power costs.

28 **Q What will determine S&P’s risk factor for the Mesaba 1 PPA?**

29 A As described above, the level of regulatory and/or legislative assurances
30 regarding cost recovery of PPA payments in NSP’s tariffs will be the primary factor

³⁵ Standard and Poor’s, Assessing U.S. Vertically Integrated Utilities’ Business Risk Drivers, September 14, 2006

³⁶ Standard and Poor’s, “Buy vs. Build”: Debt Aspects of Purchased Power Agreements, May 8, 2003

³⁷ Direct Testimony of George E. Tyson II, p. 10.

1 that will determine the risk factor that S&P assigns to the Mesaba 1 PPA. S&P's
 2 criteria regarding cost recovery, alongside their likely applicability to Mesaba 1 PPA,
 3 is summarized in the table below. Currently, S&P assigns a risk factor of 30% to NSP's
 4 existing PPAs based on the current regulatory structure regarding cost recovery of PPA
 5 payments in NSP's tariffs. Unless that regulatory structure is changed to provide
 6 reduced assurances to NSP's bond holders, I would expect the risk factor to be a
 7 maximum of 30%.

Risk Factor	S&P Description	Applicability to Mesaba 1 PPA Likely?
0%	Unlikely for any PPA	No
10-20%	Utilities where recovery of costs has been legislated	Yes , as Commission approval of the Mesaba 1 PPA would be in response to Minnesota legislation. Additional legislative assurances regarding cost recovery could be pursued as needed.
30%	Utilities with a track record of "timely and full recovery of fuel and purchased power costs"	Yes , cost recovery should be at least consistent with current regulatory treatment of NSP's existing PPAs (risk factor = 30%)
50%	Utilities with "adequate" regulatory treatment, e.g. inclusion of PPA as an operating expense in base tariffs	No, cost recovery should be no less certain than current treatment
>50%	Utilities with less than adequate certainty regarding cost recovery	No
Based on Standard and Poor's, "Buy vs. Build": Debt Aspects of Purchased Power Agreements," May 8, 2003		

8

1 **Q Could the risk factor be lower than 30%?**

2 A S&P's guidelines provide for lower risk factors based on legislative support regarding
3 cost recovery, such that S&P's risk factor for the Mesaba 1 PPA could well be 10-20%.
4 As described in Excelsior's petition and its testimony in this proceeding, the Mesaba 1
5 project already enjoys strong legislative support as the result of Minnesota's Innovative
6 Energy Project and Clean Energy Technology statutes, and Commission approval of
7 the Mesaba 1 PPA would be in response to that legislation. Additional legislation
8 providing further assurances regarding cost recovery of payments under the Mesaba 1
9 PPA could be pursued as needed or deemed appropriate by the Commission, or if the
10 Commission determined that S&P's risk factor should be minimized.

11 S&P Methodology for Assigning PPA Risk Factors and Applicability to Mesaba 1

12 **Q How do S&P's imputed debt levels for PPAs, if any, impact S&P's bond ratings?**

13 A Although S&P generally reports imputed debt amounts for a utility, and adjusts
14 credit metrics accordingly, S&P does not typically state whether the adjustments to the
15 metrics result, or even may or could result, in a change in bond rating. In fact, as
16 described earlier, S&P considers not just financial risk of PPAs but also considers the
17 impact of PPAs on business risk. S&P's published reports regarding its assessment of
18 PPA risk overall describe imputed debt levels and adjusted ratios as just one element of
19 the overall rating. The reports also state that PPA risk in total includes qualitative
20 factors, and that formulas alone cannot measure the impact of PPA risk on credit
21 quality. Thus S&P concludes:

22 "Of course, even if the effect of adjusting the capital structure to incorporate
23 take-or-pay obligations is significant, whether it affects the credit ratings of the
24 company will depend upon other qualitative factors associated with the power

1 supply strategy,”³⁸ and “No clear-cut formula can be followed in assessing the
2 impact of third-party generation on an investor-owned utility’s credit profile.”³⁹
3

4 Whatever the risk factor, imputed debt that may result, in and of itself, does not
5 impair credit quality. Any imputed debt that is created and any impact on credit metrics
6 will only be one element of S&P’s overall assessment of the impact of the Mesaba 1
7 PPA, and the base load generating capacity it will provide, on NSP’s credit quality and
8 bond ratings.

9 **Q Please summarize how the rating agencies currently treat the financial risk of**
10 **NSP’s PPAs, as measured by imputed debt.**

11 A Currently, S&P assigns a 30% risk factor to measure the financial risk of NSP’s
12 existing PPAs. Moody’s and Fitch assign little or no financial risk to NSP’s existing
13 PPAs. Current treatment is summarized in the table below.

14 Current treatment of NSP’s PPAs by the rating agencies

S&P	Moody’s	Fitch
30% risk factor assigned, resulting in \$401 million of imputed debt for 2005	Likely no imputed debt assigned	No imputed debt assigned

15
16 **Q Please summarize how the rating agencies are likely to treat the financial risk of**
17 **the Mesaba 1 PPA, as measured by imputed debt.**

18 A The level of imputed debt assigned by the rating agencies, if any, to the Mesaba
19 1 PPA will be primarily a function of the rating agencies’ assessments of assurances

³⁸ Standard and Poor’s Utilities Credit Comment, “Utilities’ risks in purchasing power,” March 26, 1990

³⁹ Standard and Poor’s Utilities Credit Comment, “Utilities’ risks in purchasing power,” March 26, 1990

1 regarding certainty of cost recovery of PPA payments provided through regulatory
2 rulings or legislative support.

3 Given that based on current regulatory treatment, the rating agencies assign
4 imputed debt levels to NSP's existing PPAs ranging from zero to 30% of the net
5 present value of the capacity payments, higher levels of imputed debt for the Mesaba 1
6 PPA are unlikely unless the MPUC modifies its current treatment of PPA contracts in
7 NSP's tariffs. This range could be 0-10% or 0-20% for the Mesaba 1 PPA, based on
8 the strong legislative support for the project.

9 **Q Could the Commission's approval of the Mesaba 1 PPA itself provide any**
10 **assurances to the rating agencies regarding the financial risk of the Mesaba 1 PPA**
11 **and certainty regarding cost recovery?**

12 **A** Yes. For example, Excelsior's Petition to the Commission that initiated this
13 proceeding recommends that the Commission's approval of the Mesaba 1 PPA be
14 based on several findings, including, for example, that:

- 15 • The Mesaba 1 PPA is prudent and in the best interests of NSP's ratepayers,
- 16 • NSP should be allowed to recover from ratepayers all costs paid under the
17 Mesaba 1 PPA (provided that NSP prudently administers the PPA),
- 18 • The Mesaba 1 project is likely to be a least cost resource under the Clean
19 Energy Technology (CET) statute.

20 These or similar findings are all recognized by the rating agencies as positive
21 factors that would minimize the financial risk of the Mesaba 1 PPA, and will confirm
22 or enhance the rating agencies' current assessment that NSP operates in a supportive

1 regulatory jurisdiction with a precedent for timely and full cost recovery of fuel and
2 purchased power costs.

3 **Q How do you respond to Mr. Tyson’s and Mr. Reed’s claims that the specific terms**
4 **of the Mesaba 1 PPA are “outside of industry norms” and “above market” and**
5 **therefore the rating agencies will assign significant financial risk to the Mesaba 1**
6 **PPA?**

7 A Excelsior’s filings in this case demonstrate that these claims are overstated and
8 unreasonable. For example, as shown in the testimony of Roger W. Gale and Thomas
9 L. Osteraas, the terms of the Mesaba 1 PPA transfer significant risks to the project
10 sponsor and away from NSP and its ratepayers, including, for example, risks of cost
11 overruns and delays during project development and construction, technology and
12 performance risks during project operations, and interest rate risks. As Excelsior has
13 also shown in its Petition and throughout its testimony in this case, the IGCC
14 technology reduces environmental and fuel price volatility risks for NSP and its
15 ratepayers compared to other alternatives, and is likely to be a least-cost resource for
16 clean, coal-fired base load power generation. As described above, these features are all
17 recognized by the rating agencies as positive risk reduction and risk transfer
18 mechanisms that can be provided by PPAs generally, and would be recognized by the
19 rating agencies as positive risk reduction and risk transfer features provided by the
20 Mesaba 1 PPA.

1 E. Conclusions

2 **Q Please summarize your findings regarding NSP's current credit quality and risk**
3 **exposure, and your conclusions regarding the likely impact of the Mesaba 1**
4 **project on NSP's credit quality.**

5 A My findings are summarized in the table below. NSP's and XEI's credit quality
6 and bond ratings are and will be driven primarily by (1) debt burdens on the
7 consolidated XEI, (2) large future construction spending plans, (3) future risks of
8 capacity shortfalls, (3) the extent of imputed debt assigned to PPA contracts, and (4)
9 future MPUC rulings regarding cost recovery. Most of these factors are interrelated.

10 Absent the Mesaba 1 project (or any other project delivering a base load
11 resource under a PPA), NSP will need to either (i) build a similar base load generating
12 resource itself, increasing already significant capital spending risks, or (ii) do nothing,
13 creating risks of capacity shortfalls and fuel price volatility. With the Mesaba 1 project
14 (or any other project delivering a base load resource under a PPA), capital spending,
15 capacity shortfall, and gas price volatility risks are avoided. Financial risk due to
16 imputed debt may increase, but only under specific circumstances, and any financial
17 risk will be reduced or offset by reductions in construction spending and capacity
18 shortfall risks provided by the base load generating resource. Finally, note that this
19 analysis is prior to consideration of likely reductions in environmental risks of the
20 Mesaba 1 PPA compared to both the utility-build and do-nothing alternatives.

21 While the net impact on credit quality is difficult or impossible to measure
22 quantitatively, it is clear that using estimated or actual levels of imputed debt assigned
23 by the rating agencies as the measure of the impact of the Mesaba 1 project on credit

1 quality systematically overstates an increase in risk and a reduction in credit quality,
2 because offsetting reductions in risk associated with capital spending plans and
3 capacity shortfalls are not taken into account. Most certainly, the alternative of not
4 proceeding with the Mesaba 1 project would have greater negative impact on NSP's
5 credit quality and bond ratings.

6 Finally, any financial risk of the Mesaba 1 PPA associated with imputed debt
7 can be minimized to the extent the MPUC's approval of the Mesaba 1 PPA provides
8 assurances regarding certainty of cost recovery of PPA payments in NSP's authorized
9 rates.

10

1

Summary – Relative Risk Exposure, With and Without the Mesaba 1 PPA

Credit Quality Issue	Source of future base load capacity in Minnesota met by		
	Mesaba 1 Contract	Self Build	Do Nothing
XEI consolidated debt profile	✓	✓	✓
Current capital spending requirements*	✓	✓	✓
Continued regulatory support regarding cost recovery	✓	✓	✓
Increased capital spending requirements	<i>No utility capital investment required</i>	✓	
Risk of delays, cost overruns and performance problems	<i>Reduced or eliminated through PPA terms</i>	✓	
Risk of capacity shortfall	<i>Power delivered provides base load capacity</i>		✓
Risk of reliance on gas-fired resources	<i>Energy prices are based on coal</i>		✓
Financial risk due to PPA imputed debt, Mesaba 1	✓ <i>BUT substantially overstated by NSP/XEI AND can be minimized with regulatory assurances regarding cost recovery</i>		
Relative risk exposure	Lower	Higher	Higher

* Note that new base load capacity for MN is not included in NSP's current capital spending plan

2

3 **Q Given that NSP's credit quality is a function of numerous interrelated factors,**
 4 **how can the Commission account for the impact of the Mesaba 1 PPA on NSP's**
 5 **credit quality, if any?**

6 **A** Rate case proceedings provide NSP the opportunity to request adjustments to its
 7 authorized capital structure and authorized costs of debt and equity, and in so doing
 8 would account for the impact of the Mesaba 1 PPA on NSP's credit quality. These

1 proceedings assure that rates are set at levels sufficient maintain financial integrity and
2 access the capital markets as needed at reasonable costs. These proceedings provide
3 NSP the opportunity to propose adjustments that are appropriate in light of NSP's
4 **overall** credit quality, risk profile, and need to access the capital markets, and also
5 consider any impact that bond ratings may have on NSP's actual costs. As a result, cost
6 of capital determinations in a rate case proceeding would necessarily include any
7 incremental impact, positive or negative, of the Mesaba 1 PPA, not based simply on
8 measures of imputed debt or potential impacts on bond ratings, but more fully and
9 completely based on NSP's credit quality and risk exposure overall. This overall
10 assessment of credit quality and determination of appropriate cost of capital in a rate
11 case proceeding could capture, for example, reductions in NSP's construction spending
12 risks as the result of the base load resource provided under the Mesaba 1 PPA.

13 **Q Does NSP's testimony consider the potential for any of the risk reductions you**
14 **have identified in its assessment of the impact of the Mesaba 1 project on credit**
15 **quality?**

16 A No, neither qualitatively nor quantitatively.

17 **Q Mr. Tyson claims that a build scenario is preferable to the Mesaba 1 project**
18 **because construction outlays would be staged over the construction period, while**
19 **imputed debt would be created as soon as the Mesaba 1 PPA is executed. Do you**
20 **agree?**

21 A I have not seen anything in the rating agencies' published criteria that confirms
22 that the rating agencies would assign imputed debt as soon as the Mesaba 1 PPA is
23 executed. Doing so is contrary to the principle that imputed debt is the result of a firm

1 financial obligation. In fact, under the Mesaba 1 PPA, there is no financial obligation to
2 make payments until the project is completed and actually delivering power.

3 To the extent the rating agencies do in fact impute debt upon contract
4 execution, Mr. Tyson's timing analysis is correct. However, I would not therefore
5 conclude from this that timing difference creates a preference for building, or an
6 increased risk from purchasing. In any case, NSP's cash outlays for construction, draws
7 on already limited sources of internally generated cash, and need to access the capital
8 markets during the construction period are real. No NSP cash outlays are required
9 during the development or construction of the Mesaba 1 project. No part of revenue
10 requirements collected from ratepayers will be required during the development or
11 construction of the Mesaba 1 project. Since there are no costs incurred by NSP during
12 this period, there is no risk for bond holders of under recovery of costs. Any imputed
13 debt that is assigned to the Mesaba 1 project, both prior to and during deliveries under
14 the PPA, is simply a paper construct used by the rating agencies as one element of a
15 multi-factor assessment of NSP's overall credit quality.

16 **Q Your conclusions indicate that the Mesaba 1 PPA is not likely to reduce NSP's**
17 **credit quality nor increase NSP's cost of capital, while increased construction**
18 **spending could. Is this consistent with industry trends?**

19 **A** Yes. I know of two independent studies that conclude that for utilities
20 generally, there is no evidence that PPAs increase a utility's cost of capital. The first
21 study was conducted by Lawrence Berkeley Laboratory (LBL) in 1994, with the results

1 published in a report titled, “Impact of Power Purchases from Nonutilities on the
2 Utility Cost of Capital.”⁴⁰ It concludes:

3 “Our principal finding is that we cannot detect any evidence to support the
4 debt-equivalence hypothesis. At least as far as the cost of equity capital is
5 concerned, we find more evidence to support the notion that utility construction
6 raises the cost of capital than that NUG [non-utility generator] purchases do.”⁴¹
7

8 The second study was conducted by the Energy Information Administration
9 (EIA) in 1994, with the results published in a report titled, “Financial Impacts of
10 Nonutility Purchases on Investor-Owned Electric Utilities.”⁴² The purpose of the report
11 was to provide an overview of the issues surrounding the financial impacts of
12 nonutility generation contracts on investor-owned utilities, including their impact on
13 investor-owned utilities’ cost of capital and rates charged to customers.⁴³ This study
14 included results from the LBL study, and added a comparative financial analysis of
15 investor-owned utilities with and without significant power purchases from non-utility
16 generators. The second analysis concluded:

17 “The data failed to support the hypothesis that utilities with significant power
18 purchases incurred a higher cost of capital than the utilities without such a
19 commitment. In fact, the evidence shows that utilities with little or no power
20 purchase commitments had to bear a slightly higher cost of capital in
21 comparison with the cost borne by the other group.”⁴⁴
22

23 The EIA report concludes that (as stated in the Executive Summary to the report):

⁴⁰ E. Kahn, S. Stoft and T. Belden, Lawrence Berkeley Laboratory, Energy & Environment Division, “Impact of Power Purchases from Nonutilities on the Utility Cost of Capital,” March 1994, LBL-34741.

⁴¹ *Id.*, p. 30.

⁴² Energy Information Administration, “Financial Impacts of Nonutility Purchases on Investor-Owned Electric Utilities,” June 1994, DOE/EIA-0580.

⁴³ *Id.*, p. ii.

⁴⁴ *Id.*, p 34.

1 “Overall, based on the available financial data using two different approaches,
2 there is no conclusive evidence that power purchases from nonutility generators
3 raised the cost of capital to the utilities which purchase the electricity.”⁴⁵

4 **Q Do you know of any independent studies that show that PPAs in fact have
5 significant impacts on credit quality, bond ratings or cost of capital?**

6 **A** I have never seen such a study.

7 Section 2.

8 Mr. Tyson’s quantitative analysis regarding the credit quality impacts
9 of the Mesaba 1 project is flawed

10 **Q Have you reviewed Mr. Tyson’s quantitative analysis regarding the likely impacts
11 of the Mesaba 1 project on NSP’s credit quality and bond ratings?**

12 **A** Yes. Mr. Tyson’s primary conclusion in his testimony is that “The Mesaba 1
13 PPA would likely cause significant credit rating downgrades – possibly below
14 investment grade,”⁴⁶ and this conclusion is based on a quantitative analysis included in
15 his testimony.

16 **Q Do you have any concerns with the quantitative analysis?**

17 **A** Yes. Mr. Tyson’s approach is too narrow, fails to consider numerous relevant
18 factors, and uses inappropriate assumptions. Further, these shortcomings all serve to
19 over-estimate reductions in credit quality and bond ratings that could occur as the result
20 of the Mesaba 1 PPA, and, since they are cumulative, represent only an absolute worst
21 case, unrealistic scenario. Specifically, I have seven concerns.

⁴⁵ Id., p. viii.

⁴⁶ Direct Testimony of George E. Tyson II, p. 2

1 **Q What is your first concern?**

2 A First, the analysis assumes that PPA financial risk resulting from imputed debt
3 is an accurate measure of the overall impact of the Mesaba 1 project on NSP's credit
4 profile. This is incorrect, as shown in Section 1. Any financial risk resulting from
5 imputed debt due to the Mesaba 1 PPA is reduced by reductions in other business risks.
6 Any assessment limited to PPA financial risk based on imputed debt, even if it could
7 be estimated accurately, will systematically and unreasonably overstate an adverse
8 impact of the Mesaba 1 PPA, or any other PPA, on credit quality and bond ratings.

9 **Q What is your second concern?**

10 A Second, the analysis estimates financial risk by using S&P's methodology for
11 assigning imputed debt to PPAs. In so doing, the analysis assumes that S&P's approach
12 is representative of Moody's and Fitch's methodologies, as well as the broader
13 market's perception of risk. As described in section 1, both Moody's and Fitch's
14 methodologies are different from S&P's, and they both assign much less financial risk
15 to NSP's existing PPAs than S&P does. Given that regulatory and legislative treatment
16 regarding cost recovery is expected to be comparable to or better than that afforded to
17 NSP's existing PPAs, there is no reason to believe Moody's and Fitch would assign
18 more risk to the Mesaba 1 PPA than they do currently to NSP's existing PPAs. The
19 reliance on S&P's methodology systematically and unreasonably overstates the
20 financial risk of the Mesaba 1 PPA.

21 **Q What is your third concern?**

22 A Third, in applying S&P's methodology, the analysis assumes that S&P will
23 assign a risk factor of 50% to the Mesaba 1 PPA. This risk factor is too high and is not

1 reasonable, and using it further overstates the financial risk of the Mesaba 1 PPA, even
2 if the assessment is intended to be limited to S&P's approach. As I described in
3 Section 1, S&P's risk factor assignments are driven by its assessment of regulatory
4 treatment regarding certainty of recovery of PPA payments. S&P currently assigns a
5 risk factor of 30% to NSP's existing contracts. A risk factor of 50% would require a
6 significant change to current regulatory treatment. Assuming regulatory assurances
7 consistent with current practices, I would expect the risk factor for the Mesaba 1 PPA
8 to be a maximum of 30%. Given the strong support for the Mesaba 1 project provided
9 by Minnesota statutes, the risk factor could be 10%-20%. Using a reasonable range of
10 risk factors of 10%-30% results in a reduction in Mr. Tyson's imputed debt estimate by
11 at least 40% to as much as 80%.

12 **Q What is your fourth concern?**

13 A Fourth, the analysis unreasonably overstates the net present value (NPV) of the
14 capacity payments likely to be payable by NSP under the Mesaba 1 PPA, further
15 overstating the financial risk of the Mesaba 1 PPA.

16 The total fixed costs shown in Exhibit GET-1 Schedule 3 will vary depending
17 on actual interest rates, inflation rates and transmission costs, and other factors and
18 could likely be lower than shown. For example, in Exhibit GET-1 Schedule 3, Mr.
19 Tyson increases base costs and transmission costs by 7.22% based on an assumption
20 for the Interest Rate Index Adjustment Factor. In the PPA, the Interest Rate Index
21 Adjustment factor is determined by the actual market yield on ten-year treasuries when
22 the EPC certification is delivered to NSP.⁴⁷ The Interest Rate Index Adjustment Factor

⁴⁷ Mesaba 1 PPA, Schedule I.

1 of 7.22% in GET-1 Schedule 3 assumes a ten-year treasury rate of 5.2% to 5.39%,
2 based on “a forecast of the applicable interest rate” between 2008 and 2010.⁴⁸ While
3 interest rates do vary, 10-year treasuries have not been at or above 5.2% since April
4 2002 (excepting a two-week period in June 2006 where they reached 5.25%). Based on
5 the average of daily ten-year treasury rates for the month of September 2006 of 4.7%,
6 the Interest Rate Index Adjustment Factor would be 1.0176. Using an average of ten-
7 year treasury rates over the past five years (4.4%), the Interest Rate Index Adjustment
8 Factor would be 1.0. As shown in Exhibit MAM-7, where I have replicated the
9 calculations used in Exhibit GET-1, Schedules 2 and 3, using an Interest Rate Index
10 Adjustment Factor of 1.0176 results in a reduction in Mr. Tyson’s imputed debt
11 estimate of 5%.

12 Taking lower risk factors and a lower interest rate adjustment factor together,
13 Mr. Tyson’s imputed debt estimates are reduced by 43% to 81%, from \$1.9 billion
14 down to \$0.4-\$1.1 billion. Detailed calculations are shown in Exhibit MAM-7.

15 **Q What is your fifth concern?**

16 A Fifth, the analysis relies on a single credit metric, the debt ratio, to determine
17 likely bond ratings, while in fact, S&P considers several credit metrics in its financial
18 assessment. Further, S&P’s published criteria downplay the importance of the debt
19 ratio relative to other credit metrics, stating “a company’s leverage is just one of many
20 components of a rating assessment. (In fact, cash flow adequacy and financial

⁴⁸ Direct testimony of Karen Hyde, p. 7

1 flexibility have long surpassed balance-sheet considerations as important rating
2 factors.)”⁴⁹

3 Graph 1 (page 14) of Mr. Tyson’s testimony shows that the debt ratio for both
4 NSP and XEI will fall below S&P’s BBB- guideline lower limit. For the two other
5 ratios for which S&P publishes guidelines, FFO interest coverage and FFO/total debt
6 (both measures of cash flow adequacy), Mr. Tyson states simply that the metrics will
7 be “weakened,” but he makes no explicit comparison to S&P’s published guidelines. In
8 fact, results for those two metrics, even using Mr. Tyson’s unreasonably overstated
9 estimates of imputed debt for the Mesaba 1 PPA, are essentially at the mid-point of
10 S&P’s guideline ranges for a BBB Corporate Credit Rating, NSP’s current Corporate
11 Credit Rating. This comparison is shown in the table below. Given that two of the three
12 metrics are still solid BBB for NSP, and given that S&P has stated it places more
13 weight on these two metrics, Mr. Tyson’s conclusion that “significant downgrades will
14 occur” is without merit, even using Mr. Tyson’s overstated estimates of imputed debt.

15 Tyson projected results vs. guideline ranges, FFO metrics for NSP

Credit Metric	S&P Guideline Range, BBB- to BBB+, Business Profile 5 ¹	Midpoint of range (mid BBB CCR)	Tyson projected results for NSP ²
FFO interest coverage	3.8x – 2.8x	3.3x	3.2x
FFO/total debt	22% - 15%	18.5%	18.2%

1. Tyson Direct, Exhibit GET-1 Schedule 6
2. Tyson Direct, Exhibit GET-2 Schedule 5

16
17 **Q What is your sixth concern?**

18 **A** Sixth, the analysis assumes that there is a direct correlation between credit
19 metrics and bond ratings. Bond ratings are based on numerous qualitative and

⁴⁹ Standard and Poor’s, Corporate Ratings Criteria 2006, p. 77.

1 quantitative factors, certainly not on one, nor even three, specific credit metrics. The
2 rating agencies themselves, including S&P, readily acknowledge that credit metrics are
3 not a direct indicator of credit quality or determinant of a bond rating. Each of the three
4 rating agencies has stated this in their published reports describing their ratings
5 methodologies. Some examples are shown in my Exhibit MAM-8.

6 With regard to S&P, the rating agency whose imputed debt methodology Mr.
7 Tyson relies upon, S&P has specifically acknowledged that its own formula is not
8 determinative of ratings, stating quite directly:

9 “Unfortunately, no clear-cut formula can be followed in assessing the impact of
10 third-party generation on an investor-owned utility’s credit profile.”⁵⁰
11

12 **Q What is your seventh concern?**

13 A Seventh, the analysis concludes that the Mesaba 1 PPA could result in bond
14 ratings below investment grade. Ignoring the fact that the analysis itself unreasonably
15 overstates the impact of the Mesaba 1 PPA on bond ratings and credit quality, any
16 bond rating for NSP or XEI below investment grade would be in large part due to the
17 other current downward pressures on NSP’s and XEI’s bond ratings resulting from
18 XEI’s aggressive construction program and XEI’s consolidated financial profile, as
19 described in section 1 of my testimony. Unless these downward pressures are removed,
20 it is inappropriate to assign the consequences of a non-investment grade bond rating to
21 any single factor, and it is certainly not appropriate to assign the consequences solely to
22 imputed debt assigned to the Mesaba 1 PPA. This concern relates to determining the

⁵⁰ Standard and Poor’s, Utilities Credit Comment, Utilities’ Risks in Purchasing Power, March 26, 1990, p. 5. (emphasis added)

1 costs that would be incurred if a down grade were to occur, and is addressed in section
2 3 of my testimony.

3 **Q Can Mr. Tyson's quantitative analysis be corrected?**

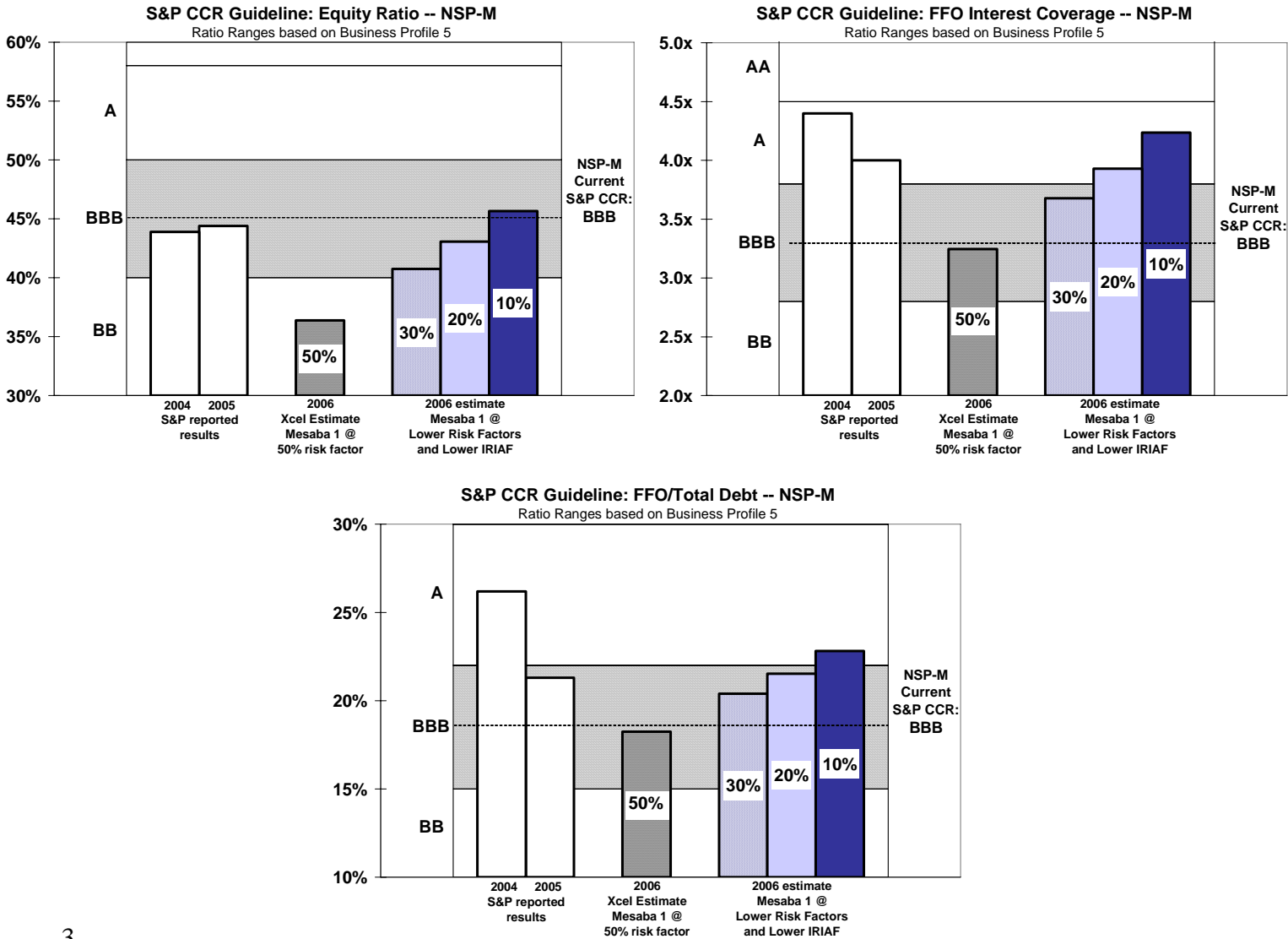
4 A Yes, but only in part. As described throughout my testimony, correcting the
5 quantitative analysis is incomplete because it measures financial risk only, cannot
6 capture the overall impact of the Mesaba 1 PPA on NSP's credit quality, and
7 systematically overstates an adverse impact on credit quality.

8 To correct Mr. Tyson's analysis at least in part, first and at a minimum, I use
9 more reasonable estimates for S&P's risk factor, specifically 30%, 20%, and 10%, I
10 use September 2006 ten-year treasury yields to project capacity payments under the
11 Mesaba 1 PPA, and I evaluate results for all three of the metrics for which S&P
12 publishes guidelines. Credit metric results with these adjustments relative to S&P's
13 published guidelines for a Corporate Credit Rating⁵¹ of BBB (NSP's current CCR) are
14 shown graphically below, with detailed calculations shown in Exhibit MAM-9. These
15 graphs show projected results compared to metrics reported by S&P for NSP for 2004
16 and 2005, and to Mr. Tyson's results. (NSP has had an S&P CCR of BBB since 2002).
17 Based on these results, taking all three metrics together, NSP's metrics fall into the mid
18 BBB range, even at my maximum recommended risk factor of 30%. Further, at a 30%
19 risk factor, there is only a slight impairment in the three metrics from 2005 levels.
20 These results show no likelihood that significant credit rating down grades would
21 occur.

⁵¹ S&P's ratio guidelines are published only for its Corporate Credit Ratings (CCR).

1
2

S&P Credit Metrics for NSP: 2004, 2005, and Projected based on adjusted imputed debt estimates and S&P guidelines for business profile 5



3

4

5 **Q Can you make any quantitative adjustments to account for the reductions in risk**
6 **that you have identified that offset financial risk?**

7

8

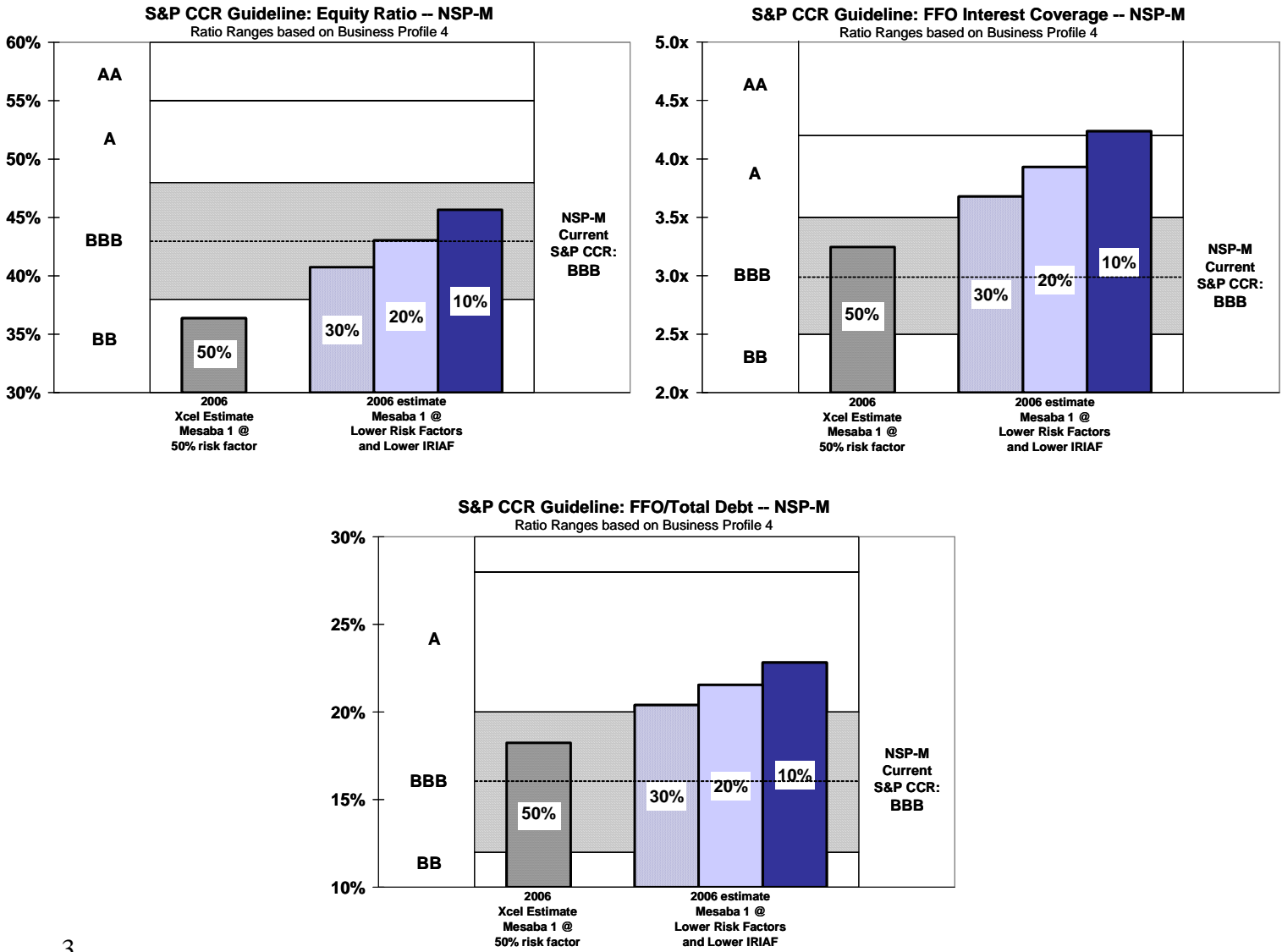
9

As a proxy for offsetting reductions in construction spending and capacity shortfall risks, I have also projected these credit metrics assuming an improved S&P business profile rating for NSP, from 5 to 4. At a business profile of 4, the benchmark

1 credit metric guidelines for a BBB CCR are reduced. S&P bases its business profile
2 ratings on several factors, and the Mesaba 1 PPA would not necessarily result in an
3 improvement in S&P's business profile rating. However, this analysis is useful as an
4 illustration because the quantitative analysis to this point measures financial risk only.
5 Credit metric results for a business profile rating of 4 are shown graphically below,
6 using Mr. Tyson's estimates of imputed debt and more reasonable estimates of imputed
7 debt, adjusted as described previously. These results show that even using Mr. Tyson's
8 exaggerated estimates of imputed debt, these three credit metrics, taken together,
9 support NSP's current BBB CCR. Further, the two cash flow metrics are comfortably
10 above the BBB guideline. Based on this analysis, there is no likelihood that significant
11 credit rating downgrades would occur.

1
2

S&P Credit Metrics for NSP: Projected
based on adjusted imputed debt estimates and S&P guidelines for business profile 4



3
4

5 **Q** You have not addressed Mr. Tyson’s quantitative analysis regarding impacts of
6 imputed debt on NSP’s parent company XEI. Why not?

7 **A** The results are similar, as shown in Exhibit MAM-9. These results are less
8 relevant however, because XEI’s metrics are driven by factors that are separate from
9 and unrelated to the financial profile of NSP. The relationship between XEI and NSP’s

1 credit metrics, credit profile and bond ratings is discussed further in Section 3 of my
2 testimony.

3 **Q Please summarize your findings regarding Mr. Tyson’s quantitative assessment**
4 **regarding the likely impact of the Mesaba 1 PPA on NSP’s credit quality.**

5 A Mr. Tyson’s testimony exaggerates the likely impact of the Mesaba 1 PPA on
6 NSP’s credit quality in several respects, but there are two primary problems: (1) he
7 considers the Mesaba 1 PPA in isolation, and fails to consider how the Mesaba 1 PPA,
8 and the base load generation resource delivered under that PPA, will reduce some of
9 the broad range of risks currently faced by NSP, both currently and prospectively, (2)
10 in considering the Mesaba 1 PPA in isolation, he relies solely on a formula that is used
11 by only one rating agency to measure one element of the overall impact of the Mesaba
12 1 PPA, and in his sole reliance on that formula, he uses “worst case” input
13 assumptions. Because all of these difficulties unreasonably overstate risk and are
14 cumulative, Mr. Tyson’s conclusion that the Mesaba 1 PPA “would likely cause
15 significant credit rating downgrades – possibly below investment grade” is
16 significantly exaggerated.

17 While the net impact of the Mesaba 1 PPA on credit quality is difficult or
18 impossible to measure quantitatively, it is clear that using reasonable assumptions
19 results in estimates of imputed debt that have much smaller impacts on NSP’s credit
20 metrics and in turn show relatively little impact on bond ratings. Any financial risk
21 attributable to the Mesaba 1 PPA will likely be offset by reductions in construction
22 spending risks and/or capacity shortfall risks.

1 Section 3.

2 Mr. Tyson's assessment of the cost of credit quality impacts

3 and the cost of remedies is flawed

4 **Q Does Mr. Tyson's assessment include identification of costs that would result from**
5 **the "significant credit rating downgrades" that he concludes are likely to occur?**

6 A Yes. Mr. Tyson's direct testimony mentions several costs that could result from
7 "significant credit rating downgrades," for example, a loss of market value of NSP's
8 bonds, and the stock and bonds of XEI (p. 2), an increase in NSP's cost of capital and
9 revenue requirements (p. 2), a reversal of the progress made to obtaining a credit
10 upgrade from S&P (p. 16), and increased difficulties in carrying out NSP's investment
11 program (p. 17). In addition, Mr. Tyson's testimony states that the Mesaba 1 PPA
12 could reduce the ratings of NSP's and XEI's senior unsecured debt to below
13 investment grade status, resulting in additional costs due to reduced access to
14 commercial paper and liquidity problems (p. 18).

15 **Q Does Mr. Tyson provide estimates of these costs?**

16 A No. Mr. Tyson's testimony is vague as to the actual costs of the credit rating
17 downgrades he predicts.

18 **Q What would be the cost of a credit rating downgrade?**

19 A Generically, the cost of a credit rating downgrade would depend on several
20 factors, including for example, the specifics regarding the downgrade, the company's
21 need to access the capital markets, specific terms in the company's agreements that can
22 be triggered by bond ratings changes, market conditions in the capital markets, and the
23 market's perception of risk relative to the company's bond ratings. For example, bond

1 ratings are one of many determinants of a utility's, and NSP's, cost of capital when
2 selling new debt and equity in the capital markets. In general, utility bonds with higher
3 ratings trade at a lower yield than utility bonds with lower bond ratings. However,
4 bond ratings are just an indicator of a utility's credit quality, and credit quality in turn
5 is just one determinant of a utility's cost of capital. There are a number of such
6 determinants. In the capital markets, buyers and sellers of bonds and equities rely on
7 numerous sources of information beyond what the rating agencies say, as well as their
8 own expertise and experience when making purchase and sale decisions. In fact, a
9 utility bond can trade at market prices that are not directly correlated to a particular
10 rating agency's bond rating. This has been the case for NSP. As mentioned in section
11 1, in NSP's recent electric rate case, Mr. Tyson testified that he believes "the pricing of
12 the Company's recent debt issuance is more in line with the Moody's ratings."⁵²

13 The Commission recognized that debt costs are not determined by bond ratings
14 just recently in its September 1, 2006 decision on NSP's 2006 general rate case,
15 stating:

16 "Debt costs are the product of *a host of factors besides credit ratings*, including
17 the terms and maturity dates of previously issued debt; revenue history and
18 prospects; perceived degree of business, financial and investment risk; and
19 general economic conditions."⁵³
20

21 Note that higher bond ratings are not by definition "better" for a utility and its
22 ratepayers than lower bond ratings, nor do they necessarily reduce overall cost of
23 capital. If that were the case, all utilities would be striving for AA or AAA ratings, at a
24 great cost to their ratepayers. In general, while improving bond ratings may reduce debt

⁵² Direct Testimony of George E. Tyson II in Docket No. E002/GR-05-1428, p. 13.

⁵³ Minnesota Public Utilities Commission, Docket No. E-002/GR-05-1428, Order issued September 1, 2006, p. 27. (emphasis added)

1 costs, other costs are likely to increase, and the improvement may not be cost-effective
2 overall. Optimal bond ratings for a utility are those sufficient to maintain financial
3 integrity, credit quality and access to the capital markets, but at the same time minimize
4 costs for ratepayers.

5 **Q What about the cost of a downgrade to below investment grade?**

6 First, as shown in my testimony above, the likelihood of a downgrade of NSP's
7 bond ratings to below investment grade, solely as the result of the Mesaba 1 PPA, is
8 speculative. Most of NSP's current bond ratings are well above investment grade. The
9 only rating at all threatened as the result of an impairment in NSP's credit quality is
10 S&P's NSP's senior unsecured rating from S&P, which is currently BBB-, one notch
11 above BB+, S&P's highest non-investment grade rating, and as shown earlier, to fall to
12 that level requires unreasonable estimates of imputed debt.

13 Second, as described in Section 1, NSP's aggressive construction spending
14 program is a major factor pushing NSP's bond ratings to their current levels, below
15 where they might otherwise be.

16 Third, the single S&P's BBB- rating is driven in large part by credit issues
17 faced by the consolidated XEI, some of which are separate from and unrelated to NSP.
18 As described earlier, in its April 2006 report on NSP, S&P makes it clear that NSP's
19 bond ratings are directly linked to the financial profile of the consolidated XEI and that
20 XEI debt is the major weakness for NSP's credit quality.

21 For example, in 2004 and 2005, credit metrics were much weaker for XEI
22 compared to NSP on a stand-alone basis. Given that S&P links NSP's senior unsecured
23 rating to XEI, all else equal, XEI's weaker credit metrics put a drag on NSP's bond

1 ratings. Credit metrics for NSP and XEI, as reported by S&P for 2005, are shown in the
 2 table below. Also shown are indicative bond ratings for both companies based on these
 3 stand alone credit metrics and based on S&P's CCR rating guidelines. This shows that
 4 based on these metrics, NSP could have an S&P CCR, and similarly an S&P senior
 5 unsecured debt rating, two notches above XEI's comparable ratings, providing a
 6 greater cushion above non-investment grade ratings. Taken together with S&P's
 7 reports on NSP, this shows that the financial profile of consolidated XEI is a factor
 8 that, at least in terms of financial risk, is separate from and unrelated to NSP, and
 9 contributes to NSP's current S&P ratings. Unless this factor is removed, it is a
 10 contributor to any S&P rating for NSP or XEI that is below investment grade. The gap
 11 between NSP and XEI's credit metrics relative to S&P's guidelines is also shown
 12 graphically in Exhibit MAM-10.

S&P Credit Metrics for 2005, NSP-M vs. Xcel Energy**
 (metrics where NSP is stronger are shaded)

Credit Metric	NSP-Minnesota		Xcel Energy		Difference, Implied CCR, NSP-M over Xcel
	Reported Result	Implied CCR*	Reported Result	Implied CCR*	
EBIT interest coverage	2.7x	-	2.1x	-	
FFO interest coverage	4.0x	A-	3.4x	BBB	+2 notches
FFO/total debt	21.3%	BBB+	15.9%	BBB-	+2 notches
Cash flow/cap ex	54.2%	-	82%	-	
Total debt/capital	55.6%	BBB	61.7%	BB+	+2 notches
Return on common equity	9.7%	-	8.6%	-	
Common dividend payout	90.6%	-	68.8%	-	
Implied CCR, based on above		BBB+		BBB-	+2 notches
Current CCR		BBB		BBB	0 notches
* for metrics with S&P published guidelines, based solely on where given metric falls within S&P ratio published guidelines for companies with a business risk profile of 5, shown for comparative purposes only between NSP-M and Xcel.					
** Standard and Poor's, Research: Northern States Power Co., April 20, 2006.					

13

14 In short, NSP's construction spending programs and the financial profile of the
 15 consolidated XEI are major contributing factors to NSP's current S&P BBB- rating on

1 its senior unsecured debt. These factors have already pushed this rating towards the
2 non-investment grade “cliff.” Assigning the costs of falling off this “cliff” to a non-
3 investment grade rating solely as the result of any financial risk that S&P might assign
4 to the Mesaba 1 PPA is inappropriate since, in fact, the risks related to NSP’s current
5 spending program and the financial profile of the consolidated XEI are continuing, and
6 would be contributing factors.

7 **Q Are XEI’s difficulties with NRG a contributing factor to NSP’s current S&P**
8 **BBB- rating on its senior unsecured debt?**

9 A Yes, based on S&P’s own reports on NSP. In a February 2006 “Research
10 Update” on NSP, S&P identifies “debt at the holding company issued during and
11 following a failed attempt to save former subsidiary NRG Energy Inc.” as a
12 contributing factor to the high degree of leverage at consolidated XEI. Since NSP’s
13 S&P’s senior unsecured bond rating is based on XEI’s corporate rating, the NRG-
14 related debt is a contributing factor to that rating.

15 **Q Mr. Tyson’s testimony raises concerns about downgrades of XEI’s bonds as the**
16 **result of the Mesaba 1 PPA. Do you agree?**

17 A No, for the same reasons I have described above. First, just as is the case with
18 NSP’s bond ratings, the likelihood of a downgrade of XEI’s bond ratings to below
19 investment grade, solely as the result of the Mesaba 1 PPA, is speculative. Second,
20 costs resulting from the predicted downgrade have not been quantified nor has a cost-
21 benefit analysis been provided. Third, regarding downgrades of XEI’s bonds to below
22 investment grade, XEI’s bond ratings are driven by factors that are separate from and

1 unrelated to NSP, making it inappropriate to automatically assign the costs of a non-
2 investment grade rating to just one of several contributing factors.

3 **Q Does Mr. Tyson consider remedies to offset the costs he has identified?**

4 A Yes. Section VI of his testimony addresses remedies to avoid the credit
5 downgrades that he predicts, and the resulting costs that he has identified. However,
6 Mr. Tyson states at the beginning of that section, “I do not believe there is any cost
7 recovery mechanism or financial adjustment that would prevent severe harm to the
8 credit ratings and cost of capital for Xcel Energy [NSP] and XEI, given the terms of the
9 Mesaba 1 PPA.”

10 **Q What cost recovery mechanism remedy does he consider?**

11 A This is not clear in Mr. Tyson’s testimony, and he appears to reject the
12 importance of the Commission’s track record and current practice regarding cost
13 recovery mechanisms in rating agencies’ assessments of PPA risk. Instead, he indicates
14 that rating agencies give much greater weight to the risk of changes in regulatory
15 policy in the future.

16 While rating agencies certainly consider the risk of regulatory change, the
17 notion that the risk of different regulatory treatment in the future somehow trumps the
18 current regulatory climate and the Commission’s prior track record in determining
19 bond ratings is unlikely absent a history of policy changes or a signal from regulators
20 that past assurances regarding cost recovery may be undone.

21 In fact, regulatory assurance regarding cost recovery is the primary factor that
22 can mitigate, minimize and limit any financial risk of the Mesaba 1 PPA from the
23 perspective of the rating agencies. In this regard, the Commission’s rulings regarding

1 cost recovery treatment for the Mesaba 1 PPA will ultimately have a great deal of
2 control over how rating agencies view the financial risk of the Mesaba 1 PPA to NSP's
3 bond holders.

4 **Q What financial adjustment remedies does he consider?**

5 A Mr. Tyson's testimony considers an adjustment to exactly offset the impact of
6 imputed debt on NSP's debt ratio, based on S&P's formula and his estimates of
7 imputed debt that will result from the Mesaba 1 PPA. The required adjustments are to
8 add additional equity to NSP's balance sheet, retire debt, and in turn increase NSP's
9 authorized equity ratio, all in amounts sufficient to exactly offset impacts of imputed
10 debt due to Mesaba 1 on NSP's debt ratio metric as measured by S&P. The increase in
11 the authorized equity ratio in turn increases revenue requirements.

12 **Q Is this an appropriate adjustment?**

13 A No, for several reasons: (i) S&P's formula only measures financial risk,
14 unreasonably overstating PPA risk overall, (ii) S&P's formula does not reflect imputed
15 debt levels that might be applied by the other rating agencies, (iii) Mr. Tyson's
16 estimates of imputed debt levels to be assigned by S&P to the Mesaba 1 PPA are
17 overstated and unreasonable, and (iv) the adjustment assumes bond ratings are directly
18 correlated to the debt ratio metric, which they are not. All of these flaws result in an
19 adjustment that would be well in excess of what would be necessary to maintain bond
20 ratings and credit quality, at great expense to ratepayers. This extra cash flow would
21 reduce NSP's risk exposure overall, and could be used, for example, to fund
22 construction spending requirements or other purposes. However, the revenue
23 requirement increase should be considered as a cost to ratepayers for reducing

1 construction spending risks or other risks, not as compensation for the credit quality
2 impacts of the Mesaba 1 PPA.

3 **Q Does Mr. Tyson compare the cost of these remedies to the costs of the credit**
4 **rating downgrades that he predicts?**

5 A No. Since Mr. Tyson does not estimate the cost of the credit downgrades that he
6 predicts, he has no basis for a comparison of the cost of a down grade to the cost of the
7 remedies that he considers.

8 **Q What do you conclude from your review of Mr. Tyson's assessment of the cost of**
9 **the credit quality impacts he predicts and the cost of remedies to avoid those**
10 **impacts?**

11 A While Mr. Tyson's testimony identifies several costs that could or might result
12 from the credit rating downgrades that he predicts, he does not estimate those costs.
13 Further, Mr. Tyson describes costs that would result should bond ratings fall below
14 investment grade. Not only is this an exaggerated worst-case scenario, but it would be
15 driven in large part by construction spending risks and by credit quality issues at NSP's
16 parent company, XEI, and as such, the incremental costs of a non-investment grade
17 rating would not be solely attributable to Mesaba 1.

18 Since the costs of predicted down grades is not estimated, it is impossible to
19 evaluate the merits of any remedy that might be available to avoid the credit rating
20 downgrades that are predicted.

21 In terms of remedies, Mr. Tyson correctly points out that his suggested
22 adjustment to NSP's capital structure based on S&P's formula for imputed debt would
23 be expensive. However, for several reasons, using S&P's formula and imputed debt

1 levels in isolation as he has done systematically overstates PPA risk, and therefore his
2 suggested remedy similarly overstates capital structure/equity ratio adjustments and
3 revenue requirement increases that would be required to offset PPA risk.

4 Section 4.

5 Conclusions and Recommendations

6 **Q Please summarize your conclusions.**

7 A My testimony shows that the rating agencies identify several risks that have an
8 impact on NSP's and XEI's bond ratings and credit quality. In particular, aggressive
9 capital spending programs throughout XEI's service territories currently put significant
10 downward pressure on NSP's and XEI's bond ratings. While rating agencies might
11 assign financial risk to the Mesaba 1 PPA, the base load generating resource that is
12 provided reduces any financial risk by reducing either NSP's construction spending
13 risks or NSP's risks of capacity shortfalls and fuel price volatility. As a result, an
14 estimate of the financial risk of the Mesaba 1 PPA in isolation is not an accurate
15 measure of the overall risk of the Mesaba 1 project to NSP's bond holders. Further,
16 any financial risk of the Mesaba 1 PPA can be limited. Financial risk as measured by
17 the rating agencies is largely determined by regulatory and legislative assurances
18 regarding cost recovery. Current regulatory treatment for NSP's PPAs has resulted in
19 the rating agencies assigning relatively little financial risk to NSP's PPAs. Legislative
20 support for the Mesaba 1 project, together with further regulatory assurances from this
21 Commission, could reduce financial risk assigned to the Mesaba 1 PPA even further.

22 My testimony also shows that NSP's prediction of "significant credit rating
23 downgrades" is exaggerated because it relies on S&P's published imputed debt

1 methodology and uses unreasonable assumptions. S&P's methodology to quantify
2 "debt equivalence" or "imputed debt" related to PPAs and its resulting impact on
3 financial ratios is not an appropriate measurement of the impact of the Mesaba 1 PPA
4 on NSP's bond ratings, credit quality, or on its cost of capital. PPA risk exposure is
5 based on qualitative and quantitative factors and cannot be reduced to a simple
6 formula. Further, S&P's "imputed debt" methodology is not representative of the
7 overall impact of PPAs on S&P's bond ratings for NSP or utilities generally, nor is it
8 representative of how other rating agencies, specifically Moody's and Fitch, evaluate
9 the impact of PPAs on bond ratings, either quantitatively or qualitatively. Using S&P's
10 formulaic approach to measure PPA risk systematically overstates PPA risk. Similarly,
11 S&P's "imputed debt" methodology is not appropriate for estimating costs of
12 incremental risk or as the basis for determining "offsets" to NSP's capital
13 structure/equity ratio, and would systematically overestimate costs and offset
14 requirements. Using S&P's methodology in this manner would increase costs
15 unnecessarily for ratepayers.

16 **Q Please summarize your recommendations.**

17 A Based on my analysis and conclusions as described above, regarding the credit
18 quality impacts of the Mesaba 1 PPA, I recommend that the Commission:

- 19 a. find that NSP's credit quality in general, and the impact of the Mesaba 1
20 PPA on NSP's credit quality in particular, are both a function of numerous
21 and interrelated factors,

- 1 b. find that the Mesaba 1 PPA reduces NSP’s risks related to capital spending
2 and capacity shortfalls, reducing any financial risk that may result due to
3 imputed debt,
4 c. reject the use of S&P’s imputed debt methodology as a measure of PPA risk
5 and as a basis for capital structure adjustments,
6 d. find that as a result, the credit quality impacts of the Mesaba 1 PPA should
7 not be addressed in this proceeding, and
8 e. find that to the extent that the Mesaba 1 PPA has an impact on NSP’s credit
9 quality, positive or negative, NSP will have the opportunity to request
10 appropriate adjustments to its authorized capital structure and authorized
11 return in the context of a future cost of capital proceeding, where all of the
12 interrelated factors that impact the risk profile and credit quality of NSP are
13 considered in total.

14 Finally, regarding the Commission’s approval of the Mesaba 1 PPA, I
15 recommend that the Commission include specific findings as described in my
16 testimony to minimize any financial risk of the Mesaba 1 PPA.

17 **Q Have other jurisdictions rejected use of S&P’s imputed debt formula to measure**
18 **impacts on credit quality or otherwise determine appropriate “offsets” to**
19 **compensate utilities for PPA risk?**

20 **A I am aware of cases in four states.**

21 First, in Connecticut, the Connecticut Department of Utility Control (DPUC)
22 rejected adjustments to PPA capacity contracts or rate surcharges proposed by

1 Connecticut Light and Power based on S&P's imputed debt formula, stating, among
2 other reasons, that:

3 "The [DPUC] can find no basis to select a formulaic aspect of one credit rating
4 agency's [S&P's] business risk methodology and convert it into an inflexible
5 cost to be recognized by regulators,"⁵⁴ and
6

7 "S&P's method of imputing debt is merely one credit rating agency's attempt to
8 assess the impact of long-term PPA/capacity contracts within a larger
9 qualitative construct, and bears no relationship to the potential actual costs that
10 electric distribution companies may experience as the result of entering capacity
11 contracts."⁵⁵
12

13 The DPUC also concluded that "should an electric distribution company's
14 exposure to capacity contracts be shown to impact its financial condition, the [DPUC]
15 will address the issue in a rate case."⁵⁶ In that same order, the DPUC also noted that
16 "relatively few jurisdictions adjust for debt equivalence."⁵⁷

17 In Florida, in a case to determine the need for a utility-built generation project
18 that included consideration of PPA bid alternatives, the Florida Public Service
19 Commission (FPSC) found that consideration of the impact of a PPA on cost of capital
20 is appropriate, but rejected Florida Power and Light's adjustment based on the S&P
21 imputed debt methodology, because it "is only one of many factors S&P considers
22 when performing an analysis" and "There are other risks and benefits that are taken
23 into account both inside and outside the scope of PPAs." In this case, the FPSC ruled
24 that going forward, "the entire circumstances surrounding the evaluation of PPAs,

⁵⁴ State of Connecticut, Department of Public Utility Control, Docket No. 05-07-18, Decision dated December 28, 2005, p. 7.

⁵⁵ State of Connecticut, Department of Public Utility Control, Docket No. 05-07-18, Decision dated December 28, 2005, p. 8.

⁵⁶ State of Connecticut, Department of Public Utility Control, Docket No. 05-07-18, Decision dated December 28, 2005, p. 10.

⁵⁷ State of Connecticut, Department of Public Utility Control, Docket No. 05-07-18, Decision dated December 28, 2005, p. 7.

1 including the appropriateness of any risk factors used, the appropriate risk factor, and
2 the presence or absence of mitigating factors shall be considered.”⁵⁸

3 In Utah, the Public Service Commission of Utah heard a case regarding avoided
4 cost pricing for large Qualifying Facilities, including extensive evidence regarding
5 imputed debt and its impacts on credit quality, In its order in that case, it found
6 insufficient evidence to persuade it that purchase power contracts have a clear impact
7 on credit ratings or costs.⁵⁹

8 Finally, the California Public Utilities Commission rejected use of S&P’s
9 reported 30% risk factor for the three California investor-owned utilities in 2004 and
10 instead adopted use of a lower risk factor, stating:

11 “Regarding DE [debt equivalence] imputation methodology, all three IOUs
12 used the S&P methodology as the starting point for their proposed DE
13 calculations because it is the most developed and transparent approach to
14 calculating DE. We agree with the IOUs and adopt the same methodology for
15 calculating DE, but with some modifications. Specifically, we believe that the
16 30% S&P risk factor is too high to be reasonable and fair to all PPAs. We find
17 it logical to make some acknowledgement that DE is a factor in utility
18 creditworthiness, but not to the degree shown in the S&P
19 methodology....Therefore, the IOUs will use a modified S&P methodology
20 that employs a 20% risk factor for all PPAs, rather than S&P’s 30% risk
21 factor.”⁶⁰ (emphasis added)
22

23 **Q Does this conclude your testimony?**

24 **A** Yes, it does.
25
26

⁵⁸ Florida Public Service Commission, Docket Nos. 020262-EI, 020263-EI, Decision dated December 10, 2002, pp 19, 20.

⁵⁹ Public Service Commission of Utah, Docket No, 03-035-14, Decision dated October 31, 2005, p. 28.

⁶⁰ California Public Utilities Commission, D. 04-12-048, December 2004.

EXHIBIT NO. ____ (MAM-1)

EXHIBIT NO. ____ (MAM-2)

EXHIBIT NO. ____ (MAM-3)

EXHIBIT NO. ____ (MAM-4)

EXHIBIT NO. ____ (MAM-5)

EXHIBIT NO. ____ (MAM-6)

EXHIBIT NO. ____ (MAM-7)

EXHIBIT NO. ____ (MAM-8)

EXHIBIT NO. ____ (MAM-9)

EXHIBIT NO. ____ (MAM-10)