

Surrebuttal Testimony  
Marvin E. McDaniel

State of Minnesota  
Before the Office of Administrative Hearings  
For the Minnesota Public Utilities Commission

*In the Matter of a Petition by Excelsior Energy Inc. for Approval of a Power  
Purchase Agreement Under Minn. Stat. § 216B.1694, Determination of Least  
Cost Technology, and Establishment of a Clean Energy Technology Minimum  
Under Minn. Stat. § 216B.1693*

OAH Docket No. 12-2500-17260-2  
PUC Docket No. E6472/M-05-1993

### **Accounting Standards**

October 31, 2006

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1 **I. INTRODUCTION**

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Q. PLEASE STATE YOUR NAME.

A. My name is Marvin E. McDaniel.

Q. HAVE YOU PROVIDED DIRECT TESTIMONY IN THIS CASE?

A. Yes. I filed Direct Testimony regarding the financial treatment of the Mesaba 1 PPA and the resulting financial consequences on Xcel Energy Inc. (“XEI”), and Northern States Power Company doing business as Xcel Energy (“Xcel Energy” or the “Company”)

**II. PURPOSE**

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY IN THIS PROCEEDING?

A. I will respond to the Rebuttal Testimony of Michael J. Hamilton. I will also comment on the relevance to my testimony of Douglas Cortez’s assertion that Mesaba Unit 1’s expected life could exceed 30 years and on Thomas Osteraas’ testimony on the level of risk transference under the Mesaba 1 PPA, as amended by Mr. Osteraas.

Q. OVERALL, WHAT IS YOUR RESPONSE TO THESE WITNESSES?

A. The Mesaba 1 PPA, as amended by Mr. Osteraas, would be subject to consolidated accounting requirements and could also be subject to capital lease and fair market value accounting requirements. None of the testimony has changed by conclusions on these issues.

1 **III. ASSESSMENT**

2  
3 Q. PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY

4 A. My Surrebuttal Testimony will show that:

- 5 • Mr. Hamilton testifies that the Mesaba 1 PPA *could be amended* to  
6 avoid adverse accounting treatment. However, the real issue is what  
7 accounting treatment would arise from the Mesaba 1 PPA, as  
8 presented.
- 9 • The amendments proposed to the Mesaba 1 PPA by Mr. Osteraas  
10 would not eliminate the need for consolidation under FIN 46(R) and  
11 possible capital lease treatment under SFAS 13.
- 12 • Special attention remains necessary to avoid fair market adjustments  
13 under SFAS 133

14  
15 Q. MR. HAMILTON TESTIFIES THAT IT IS POSSIBLE TO STRUCTURE A PPA SO THAT  
16 IT DOES NOT RESULT IN THE NEED FOR CONSOLIDATION, A CAPITAL LEASE,  
17 OR FAIR MARKET ADJUSTMENTS. DO YOU AGREE?

18 A. Yes. As I explained in my Direct Testimony, none of the Company's current  
19 PPAs require either consolidation or capital lease treatment, and none of the  
20 PPAs entered into after the pronouncement in SFAS 133 has resulted in fair  
21 market value adjustments. Mr. Hamilton makes the same point multiple times  
22 in his testimony. He basically states that the Mesaba 1 PPA could be  
23 amended so that the financially detrimental effects of SFAS 13, 133, and FIN  
24 46(R) could be avoided. However, the issue is not whether the Mesaba 1  
25 PPA *could be amended* to eliminate the harmful financial consequences I  
26 described in my testimony. Rather, my testimony was that the Mesaba 1 PPA  
27 *as proposed* by Mesaba 1 LLC *would* result in those consequences.

1

2 Q. DO THE AMENDMENTS TO THE MESABA 1 PPA OFFERED BY MR. OSTERAAS  
3 REMOVE YOUR CONCERNS?

4 A. No, they do not. While some of the amendments offered by Mr. Osteraas  
5 reduce some of the risks borne by the Company compared to the original  
6 Mesaba 1 PPA, in whole, the majority of the risks of the Mesaba 1 PPA  
7 remain with Xcel Energy, and that is what determines the accounting  
8 treatment.

9

10 Q. WHAT RISKS REMAIN WITH XCEL ENERGY AFTER THE AMENDMENTS BY MR.  
11 OSTERAAS?

12 A. The risks materially transferred to Xcel Energy, as outlined in Ms. Karen  
13 Hyde's Direct Testimony and repeated by Mr. Osteraas at page 8 of his  
14 Rebuttal Testimony, remain virtually unchanged. They include risks related  
15 to: (i) Construction, Fuel, Financing, Operations, Environmental issues, and  
16 Transmission. The amendments offered by Mr. Osteraas do not change the:  
17 (i) capacity pricing provisions; (ii) adjustments required to the pricing; (iii)  
18 variable nature of some of the pricing components; (iv) assurance of revenue  
19 streams; and (v) other factors that are the basis for my conclusion on risk  
20 transference. In essence, Mr. Osteraas' basis for comparison does not dispute  
21 that risk transference has occurred between seller and buyer under the  
22 amended Mesaba 1 PPA, but instead argues that this would be less risk than if  
23 Xcel Energy built the facility itself. By doing so, Mr. Osteraas has implicitly  
24 affirmed my conclusion that the majority of the risks have transferred to Xcel  
25 Energy and Xcel Energy stands as the primary beneficiary under the Mesaba 1  
26 PPA. This would require full consolidation of the financial results and  
27 position of Mesaba 1 LLC. Further, the accounting requirements for

1 consolidation as outlined in FIN 46(R) are not intended to compare, and are  
2 indifferent to whether a PPA is more or less risky than a self-build option.

3  
4 Q. WHY DO YOU CONCLUDE THAT THE PPA COULD BE TREATED AS A CAPITAL  
5 LEASE DESPITE THE CHANGES PROPOSED BY MESABA 1?

6 A. As I discussed in my Direct Testimony, the Mesaba 1 PPA could fail two  
7 crucial tests. First, unless further amendments were made other than those  
8 proposed by Mr. Osteraas to date, the Mesaba 1 PPA may qualify as a lease  
9 under Emerging Issues Task Force (“EITF”) 01-08 because the terms of the  
10 Mesaba 1 PPA cumulatively do not appear to require full performance by the  
11 Mesaba Unit 1 in order for payment to be required by Xcel Energy. Second,  
12 under the accounting requirements of SFAS 13, the Mesaba 1 PPA would fail,  
13 at a minimum, at least one of the four tests for a capital lease. Under the  
14 Mesaba 1 PPA, as amended, the expected capacity payments (discounted)  
15 would remain greater than 90% of the current value of Mesaba Unit 1. As I  
16 discussed in my Direct Testimony, only one of the four tests for capital leases  
17 needs to be met in order for the capital lease treatment to apply. Therefore,  
18 on this test alone, the amended Mesaba 1 PPA would result in capital lease  
19 accounting.

20  
21 Q. DO THE COMMENTS OF MR. DOUGLAS CORTEZ CHANGE THE POSSIBLE  
22 CONSEQUENCES AS TO THE SECOND CAPITAL LEASE TEST?

23 A. No. Mr. Cortez testifies that the useful life of Mesaba 1 *could* exceed 30  
24 years. The life of the Mesaba Unit 1 Plant has an effect on whether the  
25 Mesaba 1 PPA meets or exceeds 75% of the expected life of the plant. Since  
26 a base load plant like the Mesaba Unit 1 plant has not previously been  
27 constructed, predicting a prolonged life appears to be overly optimistic.

1           However, even if Mr. Cortez is correct, a term exceeding 75% of the useful  
2           life is only one of the stand-alone tests for a capital lease and for the above-  
3           stated reasons, its avoidance does not eliminate the basis upon which I  
4           conclude that the Mesaba 1 PPA could be found to be a capital lease.

5  
6           Q.   WHAT DO YOU CONCLUDE CONCERNING THE POSSIBILITY OF BEING  
7           REQUIRED TO MAKE FAIR MARKET ADJUSTMENTS UNDER SFAS 133?

8           A   My conclusions regarding SFAS 133 remain unchanged from my Direct  
9           Testimony. I agree with Mr. Hamilton's assessment of my testimony, at page  
10          10 of his rebuttal testimony:

11                   Mr. McDaniel believes that the terms of the Mesaba 1 PPA are  
12                   such that if electricity purchased under this PPA would not  
13                   qualify for normal purchase/normal sale treatment, there could  
14                   be significant fair market value changes in the contract value  
15                   that would have to be accounted for by NSP.

16  
17          He has captured the objective of my Direct Testimony regarding SFAS 133,  
18          which remains of crucial importance. Specifically, I did not testify that the  
19          Mesaba 1 PPA would require fair market value adjustments, but appropriately  
20          raised concern that the Mesaba 1 PPA may trigger unwanted financial  
21          consequences if the provisions of SFAS 133 are not adhered to. These  
22          concerns still exist and Mr. Hamilton has affirmed their potential in his review  
23          of SFAS 133 in his Rebuttal Testimony.

24  
25          Q.   MR. HAMILTON TESTIFIES THAT THE MESABA 1 PPA SHOULD BE SUBJECT TO  
26          THE SAME FINANCIAL STATEMENT TREATMENT AS THE COMPANY'S MODEL  
27          DISPATCHABLE POWER AGREEMENT. DO YOU AGREE?

28          A.   No, I do not. Although Mr. Hamilton has testified to his review of the  
29          Company's Model Dispatchable PPA, he does not make any specific

1 references to any provisions of that agreement that would support his  
2 statement of its similarities to the proposed Mesaba 1 PPA. I have outlined in  
3 my Direct Testimony specific instances that could create accounting and  
4 financial issues and have cross-referenced that testimony to the Direct  
5 Testimony of Ms. Hyde and Mr. Tyson. In addition, in this regard, Mr.  
6 Hamilton and Mr. Osteraas's Rebuttal Testimonies appear to be  
7 contradictory.

8  
9 Q. HOW DOES MR. HAMILTON CONTRADICT MR. OSTERAAS?

10 A. On pages 3 and 8 of his Rebuttal Testimony, Mr. Hamilton makes the  
11 general, but unsupported, statement that the Mesaba 1 PPA is very similar to  
12 the Company's Model Dispatchable PPA. Consequently, he derives his  
13 conclusion that the accounting treatment for the Mesaba 1 PPA should be  
14 similar to the Company's other existing PPAs. However, as I discussed earlier  
15 in this Surrebuttal Testimony, Mr. Osteraas goes to great length to explain  
16 why the Mesaba 1 PPA is unique, which uniqueness, for many reasons,  
17 supports the risk transference he suggests is appropriate. At page 5 of his  
18 testimony he states

19 But since Mesaba 1 PPA will be the first commercial  
20 arrangement relating to an IGCC plant, there are no industry  
21 norms, "standard forms" or conventional standards that apply.  
22 This is particularly true in the context of a PPA ....

23  
24 Consequently, it appears that Mr. Osteraas acknowledges the differences  
25 between the Mesaba 1 PPA and other existing PPAs.

26  
27 Q. MR. HAMILTON TESTIFIES THAT THE MESABA 1 PPA SHOULD BE SUBJECT TO  
28 THE SAME FINANCIAL STATEMENT TREATMENT AS THE CALPINE PPA. DO  
29 YOU AGREE?

1 A. No, I do not. Again, Mr. Hamilton has testified to his review of the Xcel  
2 Energy-Calpine PPA, but he does not make any specific references to any  
3 provisions of that agreement that would support his statement of its  
4 similarities to the proposed Mesaba 1 PPA. There are multiple reasons why  
5 existing Company PPAs do not meet certain tests under EITF-01-08, SFAS  
6 133, and FIN 46(R), principal of which is that they do not include the type of  
7 risk shifting contained in the Mesaba 1 PPA. Mr. Hamilton does make  
8 reference that the Mesaba 1 PPA *could be amended* to resemble the Calpine  
9 PPA so that these tests were not triggered. Again, it is possible for any  
10 agreement to be amended to pass these tests; the issue is that the amended  
11 Mesaba 1 PPA does not.

#### 12 13 IV. CONCLUSION

14  
15 Q. PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY.

16 A. The terms of the amended Mesaba 1 PPA would require financial  
17 consolidation because of the level of risks transferred from Mesaba 1 LLC to  
18 Xcel Energy. Financial consolidation would include all financial results and  
19 statements of financial position and equity of the Mesaba 1 LLC with Xcel  
20 Energy and XEI.

21  
22 The amended Mesaba 1 PPA could also require capital lease accounting if the  
23 apparent disconnect between payment and performance is deemed to create a  
24 lease. Capital lease treatment would not be required if financial consolidation  
25 were required.

26

1       The issue of fair market value adjustments is of concern and should be  
2       monitored if the provisions of the proposed PPA are modified.

3

4    Q.   DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

5    A.   Yes, it does.