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July 27, 2007

Chairman LeRoy Koppendrayer
Commissioner Phyllis Reha
Commissioner David Boyd
Commissioner Marshall Johnson
Commissioner Tom Pugh
Minnesota Public Utilities Commission
121 7th Place East, Suite 350
St. Paul, MN 55101-2147

Dear Chairman Koppendrayer and Commissioners,

As the Commission begins consideration of the Mesaba I Power Purchase Agreement (PPA) submitted by Excelsior Energy, the Department of Commerce wishes to reiterate its underlying support for the Project.

The State of Minnesota, Governor Pawlenty and Department of Commerce have been and remain supportive of Excelsior Energy's efforts to bring the 603MW Mesaba integrated gasification combined-cycle (IGCC) facility to fruition. Excelsior Energy has proposed a visionary opportunity; one with great promise.

Support for the Project is evidenced by the following:

1. Endorsement and signing into law of the original Innovative Energy Project and Clean Energy Technology statutes in 2003 by Governor Pawlenty;
2. Letters from the Governor to Federal agencies articulating the Project's merits and urging special tax consideration; and
3. Financial assistance for the Project:
    a. $9.5 million of convertible debt from the Iron Range Resources Agency,
    b. $2 million per year for 5 years from the Renewable Development Fund by the Public Utilities Commission, and
    c. $12 million of financial assistance to Itasca County for infrastructure development related to the Project's site.

State support for the Project was further shown by my Direct Testimony of September 5, 2006 in this docket. In the testimony, I outlined the positive aspects of the Mesaba facility in terms of reliability, economic development and environmental superiority and said that "the Mesaba Project could have an important place in helping meet Minnesota's energy challenges."

More recently, the 2007 Legislature adopted and Governor Pawlenty signed into law a provision that not only establishes aggressive greenhouse gas reduction goals for the State, but effectively places a moratorium on new coal plants that do not completely offset all carbon emissions pending adoption of a climate change plan. The law exempted the proposed Mesaba project from the moratorium because the Project may be able to serve as an important first step toward building the technical and physical infrastructure required for capture and sequestration of greenhouse gas emissions.

The reason for our support is simple and clear: the potential of the Mesaba facility with its emissions reduction benefits of IGCC and carbon capture capabilities is significant in a state dedicated to a diverse, clean, Minnesota-based energy supply portfolio.

Over the past years Excelsior Energy has accomplished numerous milestones:

- The Project was awarded development funding by the U.S. Department of Energy in a competitive solicitation under Round II of the Clean Coal Power Initiative.
- Executed a license for the ConocoPhillips E-Gas Technology and a joint development agreement with ConocoPhillips to start the process design engineering that is a component of the final engineering and design required prior to start of construction;
- Completed significant design optimization engineering, resulting in a plant configuration that affords flexibility to use sub-bituminous and bituminous coal as well as blends of coal with up to 50% petroleum coke;
- Secured rights to preferred and alternative sites for the Project;
- Executed Large Generator Interconnect Agreements with MISO that makes the Project's output deliverable throughout the MISO grid with modest required upgrades;
- Obtained a Project-specific authorization for a Federal loan guarantee under the Energy Policy Act of 2005; and
- Qualified for beneficial changes to the eligibility provisions for the investment tax credits for two sub-bituminous coal IGCC plants, authorized by the Energy Policy Act of 2005, so that the Project's low sulfur coal would qualify.
- Contracted for an academically in-depth plan and process study to achieve the capture and sequestration of 30% of the carbon dioxide emissions of the plant.

The Department agrees with Excelsior Energy that the Mesaba Energy Project meets the requirements of Minn. Stat. §216B.1694, subd. 1, so that the Project is an "innovative energy project." The Department's direct testimony of Dr. Eilon Amit filed in this docket bears this out.

The Department also believes the Mesaba facility fulfills each of the five enumerated benefits to the State set forth in Minn. Stat. §216B.1694, subd. 2(a)(7). Specifically, the Project will:

- Provide significant economic development benefits to the State;
- Use abundant domestic fuel sources, in the form of coal and pet coke;
- Offer energy at a potentially stable price, especially when compared to natural gas;
- Contribute to a transition to hydrogen as a fuel resource; and
- Achieve a higher level of emission reductions compared to other operating solid fuel baseload technologies.

As an Innovative Energy Project, Mesaba is exempt from the requirements for a certificate of need pursuant to Minn. Stat. §216B.1694, subd. 2(a)(1). As a result, the Department did not conduct the sort of analysis normally required for a certificate of need. Such an analysis would normally include information on alternative resource options, including analysis or evaluation of the purchasing utility's resource need or resource portfolio mix. Further, the Department did not consider or analyze any of the parties' evidence regarding resource need. To the extent the Department assessed Xcel's resource need it relied on the final results of Xcel's 2004 Integrated Resource Plan.

The capital cost and cost of electricity analysis for the Mesaba Project and a hypothetical, greenfield 600 MW Super-Critical Pulverized Coal (SCPC) facility located in central Minnesota submitted by Fluor Enterprises, Inc. in this docket, provides useful additional information for comparing the cost of energy from the Project with the cost of energy from SCPC plants.

As an Innovative Energy Project, under Minn. Stat. §216B.1694, subd. 2(a)(7) Mesaba is entitled to enter into a contract with Xcel Energy to provide 450 MW of baseload capacity and energy under a long-term contract, subject to the approval of the terms and conditions of the contract by the Commission. Contract cost is an integral part of the Commission's overarching public interest determination of any PPA. In addition, the Commission may have the authority under Minn. Stat. §216B.1694, subd. 2(a)(7) as well as other statutory provisions to increase the amount of output covered by a PPA above 450 MW.

It is with disappointment that I inform you that the Department has not reached an agreement on the terms and conditions of the PPA. The Department and Excelsior Energy have each made good faith efforts in the past six months to address Department concerns raised in my attached January 5, 2007 letter to the Administrative Law Judge. As stated in the letter, the Department seeks a PPA that contains a fixed, all-inclusive, reasonable price, plus includes non-performance protections for ratepayers and addresses carbon costs. Excelsior Energy has made a number of changes to their proposed PPA to address these issues. While we appreciate their efforts and willingness to consider these matters, they remain unresolved.

In conclusion, the State of Minnesota continues to support Excelsior Energy's efforts to bring the Mesaba facility to fruition, subject to the concerns noted above. We respectfully request that the Commission factor this support into its consideration as it evaluates the specific terms and conditions of the PPA as it balances the public interest with the goal of establishing innovative new clean energy technologies.

Sincerely,

Edward A. Garvey

EDWARD A. GARVEY
Deputy Commissioner – Energy & Telecommunications
MN Department of Commerce

EAG/cw
Attachment

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DEPARTMENT OF
COMMERCE

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January 5, 2007

The Honorable Steve M. Milhalchick
The Honorable Bruce H. Johnson
Office of Administrative Hearings
100 Washington Avenue South, Suite 1700
Minneapolis, Minnesota 55401

Dear Judges Mihalchick & Johnson:

As stated in my Direct Testimony, as a policy matter the Minnesota Department of Commerce (Department) supports Excelsior Energy's Mesaba project. It is a worthy and important project offering cutting-edge technologies, potential environmental benefits and potentially significant job creation. However, the Department's support cannot be unconditional. As with any other worthy proposal, it is necessary to balance benefits against direct costs and indirect financial risks to ratepayers.

Unfortunately, based on the facts in this proceeding, the Department concludes that the ***current*** price, terms and conditions of the Power Purchase Agreement (PPA) as filed by Excelsior Energy with the Minnesota Public Utilities Commission (Commission) on December 27, 2005 are not reasonable. The direct PPA costs payable by ratepayers are excessive and are not balanced by ratepayer benefits. Plus, the indirect financial risks to ratepayers are too high. For these reasons, the proposed PPA is not yet in the public interest.

I emphasize the word "current" in the above paragraph because the Department hopes that an outgrowth of this contentious and complex litigation will be modifications to the PPA that would allow the Mesaba project to proceed and become part of Minnesota's reliable, low-cost, environmentally superior energy system. Modifications the Department would suggest should be made are in three areas:

1. The PPA should be limited to 450 megawatts if Minn. Stat. 216B.1694 is used for justification of the project.
2. The PPA should contain fixed, all-inclusive annual prices that include all necessary costs related to required transmission from the plant to ratepayers and at least 90 percent carbon capture and sequestration. What this fixed price should be needs to be determined through negotiations, but as a starting point the Department suggests a fixed all-inclusive price averaging no more than $110 per MWh over the life of the contract.
3. There should be terms that protect ratepayers from any performance failures of the Mesaba project.

While Excelsior Energy may be correct that the Commission could order Xcel to enter into a PPA on behalf of its ratepayers for more than 450 MW, the facts of this case and underlying public policies lead the Department to conclude that limiting the PPA to 450 MW is the best course of action. Minn. Stat. Sec. 216B.1694, Subd. 2(a)(7) explicitly entitles Excelsior Energy to a contract for "only" 450 MW with Xcel subject to the terms of that statute. Any PPA amount beyond 450 MW may be considered pursuant to Minn. Stat. 216B.1963. The approach of limiting the PPA to 450 MW is also supported by your *Order on Motion for Summary Disposition* issued on October 25, 2006.

In addition, fixed, all-inclusive annual prices that run for the duration of PPAs are generally the best way to protect ratepayers; to provide efficient economic incentives (and disincentives) to the energy provider; and is, therefore, appropriate for the Mesaba PPA. This approach is consistent with the Department's recommendations on other PPAs that the Commission has approved. Energy facilities using biomass, wind and water as fuel all have fixed-price PPAs. From a ratepayer's perspective, fixed pricing is beneficial because it provides certainty and clarity of costs. It also protects ratepayers from the risk of future cost increases.

From the contracting energy provider's perspective, an all-inclusive fixed price eliminates the need for intrusive and costly regulatory oversight. In addition, under all-inclusive fixed pricing the provider has the ability and incentive to minimize the costs of operating the facility and maximize its energy production so that it "beats" the fixed price, allowing for greater profits. It also appropriately assigns the risks of cost increases, whether from construction over-runs, operational problems, fuel volatility or other areas, to the entity best able to manage those risks.

A fixed price term in the Mesaba PPA is an appropriate and reasonable modification. Minn. Stat. 216B.1694, Subd. 1 envisions that the PPA will provide an all-inclusive fixed price when it defines an innovative energy project that is "capable of offering a long-term supply contract at a hedged, predictable cost." As a coal-fueled, baseload facility, Mesaba should be able to provide capacity and energy at a relatively stable cost through the life of its operation. A fixed-price PPA addresses the fuel use questions raised in this docket, such as: How much natural gas will Mesaba use? Will Mesaba be able to get low-cost long-term coal contracts? These are questions that should be resolved before the Commission in this proceeding. A fixed-price PPA accomplishes this goal.

A Mesaba fixed price contract should include all of the costs of delivering electricity to Xcel Energy's customers. Specifically, the all-inclusive price should include the capacity and energy costs, all operation and maintenance costs, all transmission and ancillary services costs, and the costs of capturing and then sequestering no less than 90 percent of the facility's carbon emissions.

Determining the appropriate fixed price in this situation is difficult. Normally, resource selections are chosen between comparable competitive alternatives allowing a market to set the price. But this is not the case here, since Minn Stat. 216B.1964 exempts the Mesaba project from the Commission's competitive selection process. While not having direct competitive alternatives to help develop the appropriate fixed price, the Department believes a fixed price can be selected that would protect ratepayers and offer Excelsior Energy a reasonable profit incentive for its investment and electricity delivered to ratepayers. For purposes of moving these discussions forward, the Department suggests that annual fixed prices averaging up to $110 per MWh over the life of the contract be a reasonable starting point.

The Department recognizes that using an average fixed price of up to $110 per MWh as a starting point for the Mesaba PPA is significantly higher than the price of any other large scale electricity facility serving Minnesota. However, we also recognize that building any new, large baseload electricity facility is expensive, especially for a facility with cutting-edge technology like Mesaba. Moreover, this higher price must include the cost of capturing and then sequestering no less than 90 percent of the facility's carbon emissions. Carbon capture is a unique and valuable attribute of the Mesaba technology which sets it apart from other coal-fueled facilities.

While Mesaba deserves a cost premium to reflect attributes such as carbon capture, that premium must be tempered by sound economic judgment based on common sense. To put this price into perspective, $110 per MWh is twice the cost that the legislature set for energy from a biomass facility in the 2003 energy legislation (See MN Session Laws 2003, 1st Special Session, Chapter 11, Art. 2, Sec. 3, Sudb.6(c)) and higher cost by roughly one-third more than the Department's estimates for an alternative facility. Thus, the $110 per MWh figure reflects a significant premium, but not one that could be considered to be out of bounds given the expected benefits of the Mesaba project.

While an all-inclusive fixed price provides significant ratepayer protections, Commission-approved PPAs also include other reasonable protective contract provisions. The most important protections deal with instances where the contracting energy provider cannot or does not perform. Such non-performance issues arise in two instances. One is when the facility does not get built and, therefore, never provides any electricity. Another instance would be where the project is built but there are operational problems that prevent it from providing electricity for a significant amount of time. Besides having adverse consequences for the contracting facility, ratepayers are harmed because the utility, on behalf of those customers, often has to acquire electricity to replace the electricity the facility was supposed to provide, often at a higher cost than the PPA price. The Mesaba PPA should be modified to incorporate these kinds of non-performance protections.

While the Department's attached legal brief identifies a number of issues in the current Mesaba PPA, that prevent us from recommending its approval, those issues are not irreparable, as indicated by the above discussion. The Department and I look forward to working with the Excelsior Energy applicants to address these areas. And, by this letter I hope that I have outlined how these issues can be ameliorated so the Mesaba facility can become part of Minnesota's reliable, low-cost and environmentally superior electricity system.

Sincerely,

EDWARD A. GARVEY
Deputy Commissioner – Energy and Telecommunications Division
Minnesota Department of Commerce

EAG/cw

STATE OF MINNESOTA)
) ss
COUNTY OF RAMSEY)

AFFIDAVIT OF SERVICE

I, **Linda Chavez**, being first duly sworn, deposes and says:

That on the **27th** day of **July**, **2007**, she served the attached **Minnesota Department of Commerce – Comments Supporting Excelsior**

Docket Number(s): **E6472/M-05-1993**

by depositing in the United States Mail at the City of St. Paul, a true and correct copy thereof, properly enveloped with postage prepaid.

by personal service

by express mail

by delivery service

X by electronic file

X by e-mail

to all persons at the addresses indicated below or on the attached list:

/S/LINDA CHAVEZ

____

Subscribed and sworn to before me

this 27th day of July, 2007

/s/ Vickie Harty

Vickie L. Harty
Notary Public – Minnesota
My Commission Expires Jan 31, 2011

E6472/M-05-1993

In the Matter of a Petition by Excelsior Energy, Inc., …
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