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Direct Testimony and Schedules
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

September 5, 2006

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I. INTRODUCTION AND QUALIFICATIONS

Q. PLEASE STATE YOUR NAME.

A. My name is Marvin E. McDaniel.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Xcel Energy Services Inc. I am Vice-President and Assistant Controller for Xcel Energy Inc. ("XEI").

Q. FOR WHOM ARE YOU TESTIFYING?

A. I provide testimony on behalf of Northern States Power Company doing business as Xcel Energy ("Xcel Energy" or the "Company").

Q. PLEASE SUMMARIZE YOUR QUALIFICATIONS AND EXPERIENCE.

A. I received a Bachelors Degree in Business with a Major in Accounting and a Minor in Economics in 1982 from Colorado State University. I received a Masters Degree in Finance and Accounting from Regis College in June of 1990. I am a certified public accountant with an active license in the State of Colorado. I have held several positions in the Corporate Accounting Department and am currently Vice-President and Assistant Controller of XEI. In that capacity, I am responsible for corporate accounting, business area budgeting and forecasting, certain financial functions related to the commercial operations, regulatory accounting, revenue accounting, and commercial operations accounting. My resume, which contains a more detailed description of my experience and qualifications, is provided as Exhibit___(MEM-1), Schedule 1.

II. OVERVIEW

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony addresses the application of specific accounting standards to MEP-I LLC's ("Mesaba 1 LLC") Power Purchase Agreement ("Mesaba 1 PPA") and describes the resulting impact on the financial statements of the Company and its parent XEI.

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS.

A. Based on my review and analysis of the available information, I conclude that:

1) The terms and conditions of the Mesaba 1 PPA would result in financial consolidation of Mesaba 1 LLC in the Company's financial statements.
2) If consolidation were not required, capital lease treatment could be required, resulting in the Mesaba Unit 1 facility and associated payment obligations being included in the Company's balance sheet.
3) The Company might also be required to apply "fair value accounting" to the Mesaba 1 PPA, which could lead to significant volatility in the Company's financial statements.

Q. ON WHAT DO YOU BASE YOUR CONCLUSIONS?

A. My conclusions are based on: (i) an analysis of effects of the terms and conditions of the Mesaba 1 PPA on the Company and certain information contained in materials provided by Excelsior Energy Inc., ("Excelsior") the owner of Mesaba 1 LLC; and (ii) the application of Generally Accepted Accounting Principles ("GAAP") to those terms and conditions and information, as specified in various Statements of Financial Accounting Standards and Interpretations. I also reviewed the testimony of Ms. Karen

Hyde, which verified my assessment of the effect of the terms and conditions of the Mesaba 1 PPA on the Company. Finally, I reviewed the proposed PPA between Mesaba 1 LLC and the Company and certain related discovery responses by Mesaba 1 LLC with regard to this project and the PPA.

Q. HAVE YOU PREPARED PRO-FORMA RESULTS OF YOUR CONCLUSIONS FOR THE COMPANY AND XEI?

A. Yes. I provide pro-forma results of consolidation and capital lease treatment for the Company and XEI in Exhibit___(MEM-1), Schedules 2 and 4.

III. ACCOUNTING STANDARDS

Q. WHICH STANDARDS ARE MOST SIGNIFICANT TO YOUR ANALYSIS OF THE ACCOUNTING TREATMENT OF THE MESABA 1 PPA?

A. Three accounting standards are most significant: (i) Financial Interpretation No. 46(R), Consolidation of Variable Interest Entities – An Interpretation of Accounting Research Bulletin 51 ("FIN 46"); (ii) Statement of Financial Accounting Standard 13, Accounting for Leases ("SFAS 13"); and (iii) Statement of Financial Accounting Standard 133, Accounting for Derivative Instruments and Hedging Activities ("SFAS 133").

A. Financial Interpretation 46

Q. WHAT IS FIN 46?

A. FIN 46 is an accounting interpretation that provides authoritative accounting guidance regarding the requirement to consolidate the financial results of an entity based on certain conditions.

Q. WHAT IS FINANCIAL CONSOLIDATION?

A. Financial consolidation is the process of combining the financial position and results of operations of multiple entities or subsidiaries into one reportable set of financial statements, including balance sheets, income statements, statements of cash flows, and statements of stockholders equity.

Q. HOW DOES FIN 46 IMPACT FINANCIAL CONSOLIDATION?

A. Historically, the financial consolidation of entities generally occurred when an owner held a majority ownership or voting interest in an investment, creating a subsidiary. An example of such consolidation is XEI's sole ownership of the Company. FIN 46, originally issued on January 17, 2003 and revised on December 24, 2003, clarified that financial consolidation principles apply to certain entities in which the controlling financial interest is something other than ownership interest. FIN 46 emphasizes the concept of a variable interest when determining whether financial consolidation must occur. FIN 46 fundamentally requires the business entity absorbing the majority of the variable interest associated with a variable interest entity – regardless of the level of ownership, voting interests, or investment – to consolidate that entity into its financial statements.

Q. WHAT IS A VARIABLE INTEREST?

A. A variable interest is an interest in an entity that absorbs the expected losses or returns of an entity. Variability is basically a function of risk. Risk transference creates variability for the entity absorbing the risk.

Q. DOES FIN 46 APPLY TO PURCHASED POWER CONTRACTS?

A. Yes. FIN 46 states that a "derivative instrument" (such as the Mesaba 1 PPA) can absorb the variability of an entity (such as the Mesaba 1 LLC) and must be evaluated under FIN 46. The derivative instrument may transfer substantially all of the risks of ownership of an entity or asset (in this case, Mesaba 1 LLC) to another business (the Company), which would require financial consolidation, even though there is no transfer of legal ownership.

Q. DOES THE MESABA 1 PPA MEET THE DEFINITION OF A DERIVATIVE?

A. Yes, it does. While the definition of a "derivative instrument" is technical, the Mesaba 1 PPA includes all of the elements of that definition. There are four primary elements to the definition of a derivative instrument. They are: an underlying, a notional, little or no initial investment, and net settlement capability. First, the derivative instrument has to have an "underlying," a variable related to the delivered commodity or product that affects the settlement price, but is not the actual commodity or product itself. A "notional value," is a quantity that also impacts the settlement price. The Mesaba 1 PPA includes a notional value and has numerous references to underlying pricing provisions. As such, these characteristics are met. In addition, the Mesaba 1 PPA requires little or no initial investment by the Company. Finally, the Mesaba 1 PPA facilitates "net" settlement. As there is an active energy trading market, the ability to utilize net settlement is achieved. Generally all purchased power contracts, including the Mesaba 1 PPA, meet this last requirement.

Q. WHAT IS THE BASIS FOR FINANCIAL CONSOLIDATION IN FIN 46?

A. FIN 46 introduces the concept of a primary beneficiary. As defined in FIN 46, a primary beneficiary is the entity that absorbs the majority of the variability or risks of another entity. This concept bases the requirement to consolidate on risk, rather than ownership. It is not necessary to have any equity ownership, much less a majority of that ownership for consolidation to be required. If an entity can transfer the risk of ownership away from its equity interest, FIN 46 requires consolidation.

Q. WHAT KINDS OF RISKS CAN BE TRANSFERRED IN A PURCHASED POWER CONTRACT?

A. A number of risks can be transferred through a derivative or purchased power contract, including the risks of construction, commodity prices, operations, environmental regulation and costs, financing, and many others. Any instance of the equity owner receiving a full or partial guarantee of cost recovery through a purchased power contract transfers risk from the seller to the buyer. For example, if a contract provides that construction cost overruns are either shared with or fully passed from the seller to the buyer, risk has transferred.

Q. DO ALL PURCHASED POWER CONTRACTS RESULT IN FINANCIAL CONLIDATION?

A. No. To date, none of the Company's purchased power contracts have included terms and conditions requiring financial consolidation because the majority of the risks have remained with the equity owners of the power generating units. While some of the terms and conditions contained in the Mesaba 1 PPA can be found in other purchased power contracts entered into by the Company, no other purchased power contract contains the cumulative level of risk-shifting found in the Mesaba 1 PPA.

Q. WOULD THE MESABA 1 PPA RESULT IN FINANCIAL CONSOLIDATION UNDER FIN 46?

A. Based on available information, including the terms and conditions of the Mesaba 1 PPA, it is my opinion that FIN 46 would require the financial consolidation of the Mesaba 1 LLC with the Company, which would also lead to inclusion in the financial statements of the Company and XEI.

Q. WHY WOULD FINANCIAL CONSOLIDATION BE REQUIRED?

A. As explained by Ms. Hyde, the Mesaba 1 PPA transfers most of the risks of the Mesaba Unit 1 to the Company, including:

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Q. IS THERE OTHER SUPPORT FOR YOUR CONCLUSION REGARDING THE TRANSFER OF RISKS TO THE COMPANY?

A. Yes. Analyses prepared by financial advisors to Excelsior Energy Inc. support my conclusion that the Mesaba 1 LLC will be insulated from these risks by the Mesaba 1 PPA. [TRADE SECRET BEGINS

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Q. HAVE YOU PREPARED PRO-FORMAS SHOWING THE EFFECTS OF SUCH FINANCIAL CONSOLIDATION ON THE BALANCE SHEETS OF THE COMPANY AND XEI?

A. Yes. Using the pro forma financial information provided by Mesaba 1 LLC in discovery, I have created a potential consolidation analysis for the Company and XEI, which are attached as Exhibit___(MEM-1), Schedule 2. I based my analysis on the XEI and Company December 31, 2005 SEC Form 10-Ks and the projected Mesaba 1 LLC financial statements as of the beginning of commercial operations (in 2011). While there are clearly timing differences, this analysis shows the magnitude of the effects of possible consolidation.

Q. WOULD SUCH FINANCIAL CONSOLIDATION HAVE SIGNIFICANT IMPACTS ON THE COMPANY?

A. Yes. The impacts would be very significant, especially given the very large amount of projected debt associated with Mesaba Unit 1. The pro-forma indicates that the Company's equity ratio could be decreased by approximately 6% (from 51% to 46%). A proportional decrease is evident at the parent company level for XEI. Mr. George Tyson and Mr. John Reed will discuss some of the capital market impacts that would occur and the resulting need to increase equity along with the associated rate consequences.

B. SFAS 13

Q. WHAT IS SFAS 13?

A. SFAS 13 is a financial accounting standard that addresses the accounting for leases, including capital leases.

Q. WHAT IS A CAPITAL LEASE?

A. A capital lease is an agreement or other contractual arrangement that places an entity in operational and financial control of an asset or group of assets. The agreement need not require occupancy or possession of the asset or facility to transfer control to the lessee from the lessor.

Q. WHAT ACCOUNTING TREATMENT DOES SFAS 13 REQUIRE FOR CAPITAL LEASES?

A. It requires the lessee to record the asset(s) under lease on its financial statements to simulate ownership of those asset(s) with an off-setting capital lease liability. The lessee is required to record the lesser of the fair value of the asset or the present value for all future payments to the lessor. Certain financial disclosures are also required in the footnotes to the financial statements.

Q. HOW DOES SFAS 13 RELATE TO FINANCIAL CONSOLIDATION?

A. The application of SFAS 13 is secondary to the application of FIN 46. In other words, if FIN 46 applies and requires full consolidation of the entity, then SFAS 13 would be not applicable.

Q. CAN SFAS 13 APPLY TO PURCHASED POWER CONTRACTS?

A. Yes. First, a determination has to be made if the purchased power contract qualifies as a lease under the definition provided in Emerging Issues Task Force Issuance 01-08 (EITF 01- 08). In this circumstance, the Mesaba 1 PPA could qualify as a lease because the terms of the Mesaba 1 PPA cumulatively do not require full performance by Mesaba Unit 1 in order for payment to be required.

Q. WHAT ATTRIBUTES OF A PURCHASED POWER CONTRACT WOULD MAKE IT A CAPITAL LEASE UNDER SFAS 13?

A. There are essentially four tests to determine if a lease is a capital lease under SFAS 13:

- Whether the net present value of the lease payments required under the lease agreement exceed 90% of the current value of the asset.
- Whether the lease term is greater than 75% of the expected life of the asset.
- Whether a bargain purchase option exists in the agreement.
- Whether the lease transfers ownership of the asset to the lessee at the end of the lease term.

The purchased power contract is only required to pass one of these four tests to qualify as a capital lease.

Q. DO ALL PURCHASED POWER CONTRACTS RESULT IN CAPITAL LEASE ACCOUNTING?

A. No. To date, none of the Company's purchased power contracts have required capital lease accounting.

Q. WOULD THE MESABA 1 PPA RESULT IN CAPITAL LEASE ACCOUNTING UNDER SFAS 13?

A. Based on the overall nature of the terms and conditions of the Mesaba 1 PPA and other available information, it is my opinion that the Mesaba 1 PPA could be classified as a lease. If so, SFAS 13 would require capital lease accounting, leading to inclusion in the Company's balance sheet and in the balance sheet of XEI.

Q. WHY DO YOU THINK THAT CAPITAL LEASE ACCOUNTING WOULD BE REQUIRED IF THE MESABA 1 PPA QUALIFIES AS A LEASE?

A. I applied the first test, which measures the discounted value of the expected capacity payments under the Mesaba 1 PPA against the current value of Mesaba Unit 1. Because the discounted value was significantly greater than 90% of the current value, it qualifies and should be classified as a capital lease. My capital lease test is attached as Exhibit___(MEM-1), Schedule 3 and is based upon and referenced to the capacity payment calculations presented in Mr. George Tyson's Exhibit___(GET-1), Schedule 2 to his testimony.

Q. DID YOU APPLY ANY OF THE OTHER CAPITAL LEASE TESTS?

A. No, I did not as it was not required to determine the capital lease classification. While I did not conduct a specific study of whether the proposed 25-year lease term is greater than 75% of the expected life, the Company assumes generation plant lives of approximately 30 to 40 years for established proven generation technology. The Commission has accepted such assumed lives when approving our remaining life depreciation rates. I expect that this IGCC technology would substantiate an expected life at the low end of that range, resulting in the Mesaba 1 PPA failing that test and providing further evidence that it qualifies as a capital lease.

Q. WHEN WOULD THE EFFECTS OF THIS CAPITAL LEASE TREATMENT BECOME EFFECTIVE?

A. Capital lease treatment becomes effective when the underlying contract is signed. As a result, capital lease treatment of the Mesaba 1 PPA would become effective in 2007, based on the timetable proposed by Mesaba 1 LLC.

Q. HAVE YOU PREPARED PRO-FORMA STATEMENTS SHOWING THE EFFECTS OF CAPITAL LEASE TREATMENT?

A. Yes. Using the pro forma financial information provided by Mesaba 1 LLC in discovery, I have created pro-forma balance sheets for the Company and XEI, which are attached as Exhibit___(MEM-1), Schedule 4. I based my analysis on the XEI and Company December 31, 2005 SEC Form 10-Ks. This analysis indicates that the Company's equity ratio could decrease by 12 % (from 49 % to 37%). Similar to my example on consolidation effects, I have also applied these effects at the parent company level, XEI. These also show a sizable decrease in the equity ratio.

Q. WOULD TREATMENT OF THE MESABA 1 PPA AS A CAPITAL LEASE HAVE SIGNIFICANT IMPACTS?

A. Yes, the impacts would be very significant, and most, if not all, of the effect would occur in 2007. Mr. Tyson and Mr. Reed will discuss some of the capital market impacts and the resulting need to increase equity along with the associated rate consequences that would occur.

C. SFAS 133

Q. WHAT IS SFAS 133?

A. SFAS 133 is a financial accounting standard regarding derivative instruments and hedging activities. SFAS 133 requires that an entity recognize all derivatives (unless exempted or qualified as a hedge) at fair value with the fair value adjustment reflected in current earnings. This fair value approach, by definition, increases income statement volatility. A qualifying hedge permits the fair value adjustment to be reflected on the balance sheet of the Company, while a full exemption permits the derivative to follow normal accrual accounting. This fair value approach is known as mark-to-market accounting. If an effective hedging relationship is present, the offset of the fair value adjustment is reflected in equity. This accounting treatment can mitigate the income statement volatility. This treatment is known as hedge accounting.

Q. WHAT IS THE RATIONALE FOR SFAS 133?

A. SFAS 133 ensures that financial statements more accurately reflect the fair value of the assets and liabilities as they relate to derivative instruments. Traditionally, derivative instruments were not reflected on financial statements and certain arrangements with significant economic effects were not presented. As these instruments can now be more easily converted to fair value, SFAS 133 requires financial statements to reflect this economic substance and volatility and has removed the obstacles to more accurately reflect the actual costs, obligations, and impacts of certain financial instruments on a company.

Q. ARE PURCHASED POWER CONTRACTS SUBJECT TO SFAS 133?

A. Yes. Most long-term purchased power contracts meet the SFAS 133 definition of a derivative instrument and are therefore subject to SFAS 133.

Q. HOW HAVE LONG-TERM PURCHASED POWER CONTRACTS BEEN ACCOUNTED FOR UNDER SFAS 133?

A. Historically, long-term purchased power contracts have qualified under the *normal purchase* or *normal sale* scope exception. This exception acknowledged that these contracts were derivatives; however, based on certain characteristics of the contracts and based on a utility's intent not to realize the fair value of the contract, the utility is permitted to follow normal accrual accounting rules. As power was purchased and delivered under these contracts, the associated expenses and liabilities were recorded. As the amounts came due, they were paid. This accounting has historically been consistent with the ratemaking treatment.

Q. WHAT IS REQUIRED TO QUALIFY FOR THIS EXEMPTION?

A. The purchaser must demonstrate that: (i) the contract calls for the purchase of a commodity that is expected to be used in the normal course of business, (ii) the contract also must meet certain "capacity" requirements, and (iii) the contract must have price adjustments that are clearly and closely related to items being escalated.

Q. WHAT CONCERNS DO YOU HAVE REGARDING THE MESABA 1 PPA?

A. It is critical that any PPA agreed to by the Company and approved by the Minnesota Public Utilities Commission qualify under the scope exception.

Q. WHY IS IT IMPORTANT TO QUALIFY PURCHASED POWER CONTRACTS UNDER THE SCOPE EXCEPTION?

A. Long-term purchased power contracts failing to meet the scope exception are required to be recorded at fair value on the financial statements of the utility. Due to the long-term nature of these contracts and potentially substantial divergence between market and contractual prices, this accounting may result in significant volatility in the financial statements of the utility.

Q. DO ALL PURCHASED POWER CONTRACTS RESULT IN FAIR VALUE ADJUSTMENTS?

A. No. Subsequent to the release of the accounting interpretations noted above, we have not entered into any long-term purchased power contract that fails to qualify for the exemption.

Q. WHAT ARE YOUR EXPECTATIONS OR CONCERNS WITH REGARD TO SUCH FAIR MARKET ADJUSTMENTS?

A. XEI's experience with such valuations is that these adjustments are both volatile and material. The volatility is caused by external market forces outside of the control of the company and will add unwanted variation to our financial statements that is typically not reflective of the risk inherent in the contract. In addition, these adjustments may be very material.

Q. WOULD FAIR VALUE TREATMENT OF THE MESABA 1 PPA HAVE SIGNIFICANT IMPACTS?

A. Yes, the impacts could be very significant based upon the tenor and the purchases made under this contract. Mr. Tyson, will discuss these impacts, if incurred.

IV. CONCLUSION

Q. CAN YOU SUMMARIZE YOUR CONCLUSIONS?

A. Yes. Based on the terms of the Mesaba 1 PPA, and available information, the Mesaba 1 PPA would require financial consolidation because of the level of risks transferred from Mesaba 1 LLC to the Company. Financial consolidation would include consolidation of the income statements, balance sheets, statements of cash flow, and statements of stockholders' equity of the Mesaba 1 LLC with the Company, and in turn, XEI. My pro-formas show some of the effects of such financial consolidation on the Company and on XEI for the year 2005 as if the Mesaba Unit 1 was at completion.

The terms and conditions of the Mesaba 1 PPA could also require capital lease treatment if the disconnection between payment and performance is deemed to create a lease. Capital lease treatment would not occur if financial consolidation were required. Capital lease treatment would require that the entire value of the Mesaba Unit 1 be recorded as a component of assets and liabilities on the balance sheet of the Company, which in turn would be reflected in the balance sheet of XEI. My pro-formas show some of the effects of such capital lease treatment on the Company and on XEI.

Finally, special attention must be paid to the terms and conditions of any PPA to avoid fair market value adjustments.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

Statement Of Qualifications

Marvin E. McDaniel

I received a Bachelors Degree in Business with a Major in Accounting and a Minor in Economics in December of 1982 from Colorado State University. I received a Masters Degree in Finance and Accounting from Regis College in June of 1990. I am a Certified Public Accountant in the State of Colorado.

I began my career with Public Service Company of Colorado in December of 1987 as a general accountant. I have held several positions in the Corporate Accounting Department including Financial Accounting Coordinator, Director of Business Unit Accounting and Consulting, and Director of Corporate Accounting. I have had responsibilities for general and financial accounting, internal management reporting, the corporate budget function, Service Company accounting for the former NCE Service Company, CPUC, FERC, and SEC reporting, and SEC compliance filings.

I also held positions in the Rate department with responsibilities specifically in Gas Rates. As part of that function and in my role in the accounting areas, I have submitted testimony in various State and Federal regulatory proceedings. These proceedings are listed at the end of this statement.

I am currently Vice-President and Assistant Controller of Xcel Energy, Inc. I am responsible for corporate accounting, business area budgeting and forecasting, certain financial functions related to the company's commercial operations, regulatory accounting, revenue accounting, and commercial operations accounting.

Previous Testimony:

Public Utilities Commission of Colorado	Docket 04A-050E
Public Utilities Commission of Colorado	Docket 02S-315EG
Public Utilities Commission of Colorado	Docket 98S-518G
Public Utilities Commission of Colorado	Docket 97A-622G
Public Utilities Commission of Colorado	Docket 981-389G
Public Utilities Commission of Colorado	Application 34815
Public Utilities Commission of Wyoming	Docket 30005-GR-99-70
Public Utilities Commission of Texas	Docket 22351
Public Utilities Commission of Texas	Docket 26186
Federal Energy Regulatory Commission	Docket RP93-99-000
Federal Energy Regulatory Commission	Docket RP96-190-000

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