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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

EXCELSIOR ENERGY, INC.

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

PREPARED REBUTTAL TESTIMONY OF

MARGARET A. MEAL, CFA

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

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

Q On whose behalf are you testifying?

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

Q Please describe your qualifications.

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

Scope and Summary

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

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

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

Q Please summarize your findings.

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

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

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

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

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

Q Please describe how your testimony is organized.

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

A. Risks for NSP as identified by the rating agencies

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

C. Regulatory Risks

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

E. Conclusions

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

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

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

Section 1.

Qualitative assessment of NSP's primary risks, risk exposure and credit quality, and changes in risk exposure with the Mesaba 1 project

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

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

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

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

A. Risks for NSP as identified by the rating agencies

Q Which rating agencies rate NSP and XEI bonds?

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

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

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

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

Q What are NSP's and XEI's current bond ratings?

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

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	

[1] Standard and Poor's, "Corporate Ratings Criteria 2006," p. 14, available on S&P's website.

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

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

Q Do Fitch and Moody's base NSP's bond ratings on the bond ratings or credit quality of XEI?

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

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

A Broadly, bond ratings are determined based on a rating agency's assessment of numerous qualitative and quantitative factors, based on a review of the company, its market, management and financial structure, identification of demand, supply, 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.

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

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

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

- Large construction spending requirements
- Adverse regulatory rulings regarding cost recovery

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

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

S&P	Moody's	Fitch
• adverse or less supportive regulatory rulings • Xcel consolidated debt burden (identified as sole weakness)	• adverse or less supportive regulatory rulings • higher capital spending • increased debt leverage • operating problems	• adverse or less supportive regulatory rulings • cost overruns on construction • increased debt leverage

Additionally, S&P specifically identifies high levels of debt leverage of the consolidated XEI as a credit concern, stating that the only NSP rating factor weakness is that "parent company's debt increases utilities' debt service burden."[4]

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

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

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

A Isolating or subtracting out the impact of specific credit issues on bond ratings and credit quality is difficult and would require both quantitative and qualitative adjustments. In this case, however, given the clear disparity between S&P's senior 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.

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

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

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

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

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

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

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

Fitch: "The new rating also takes into consider [sic] potential credit concerns 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.

several years, with attendant risks of cost overruns or difficulties in getting timely regulatory orders." [8]

"Primary rating concerns are an unfavorable outcome in NSPM's upcoming electric base rate case filing or cost overruns of the MERP project."[9]

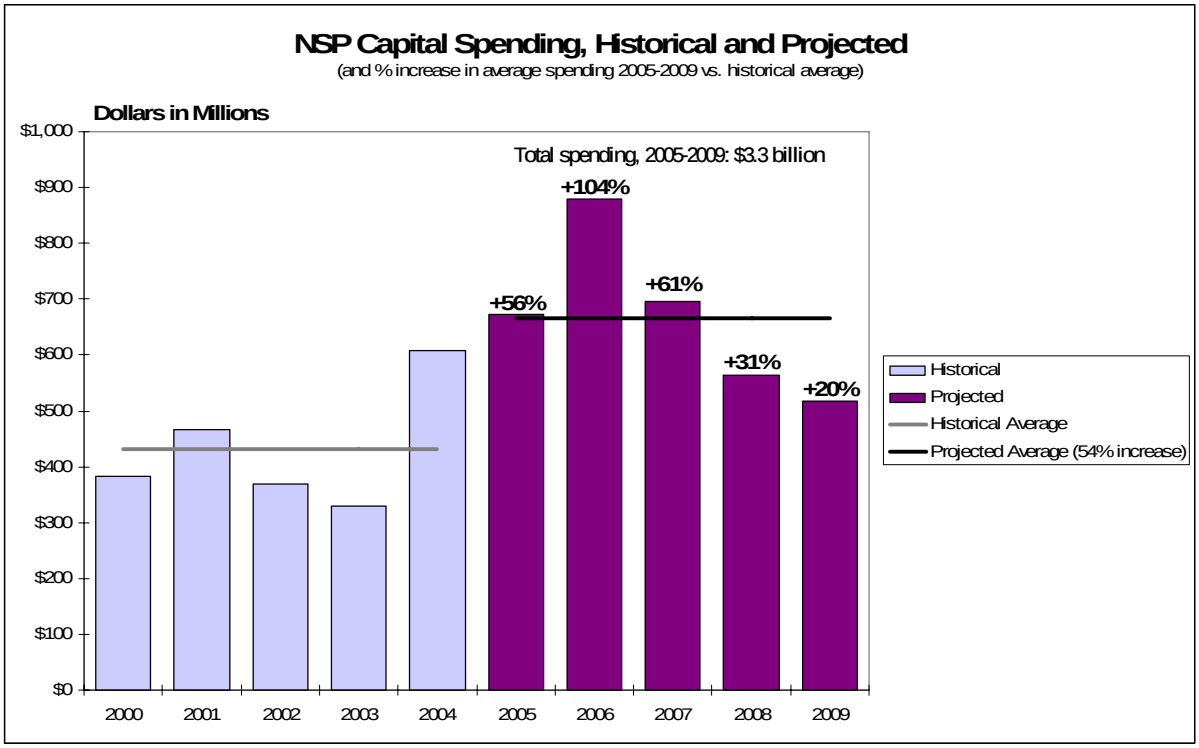
"Rating concerns relate to the risks of unfavorable rate decisions and cost overruns on specific projects."[10]

Q What other evidence do you have regarding NSP's capital spending plans?

A Both NSP and XEI's planned capital spending programs are large. As noted by Fitch in 2005, XEI "estimates that it will spend ***6.9 billion*** on utility assets [2005] through 2009."[11] This amount covers core capital spending, the Minnesota Emissions Reduction Project (MERP) and Public Service Company of Colorado's (PSCo's) Comanche 3 project, and planned spending on these programs alone over just five years amounts to nearly 50% of $14.1 billion in net property, plant and equipment assets held by XEI at the end of 2004.[12]

Roughly $3.3 billion of this spending (nearly 50% of the total) is planned for NSP, and will push NSP's capital programs well above historical levels. As shown in the chart below (with details included in Exhibit MAM-4), NSP's capital spending 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.



These are large increases in capital spending, and as described further below, these estimates do not include projects that have subsequently been added to the plan. Note that this spending plan includes core capital spending and MERP expenditures only, and does not include any new construction programs to provide additional base load generating capacity to serve NSP's customers. Absent the Mesaba 1 PPA and the base load generating capacity it provides, NSP's spending plans would be increased even further, putting even greater pressure on NSP's credit quality, bond ratings and cost of capital.

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

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

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

Q Are internally generated funds likely to be sufficient to fund NSP's existing capital spending requirements?

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

- $700 million, CapX 2020, 2009-2012
- $ 4 million, Colorado IGCC, 2007-2009, with additional amounts thereafter
- $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.

- $60 million, CAIR, 2007-2008, with additional amounts thereafter
- $1 billion, Monticello/Prairie Island, 2006-2015
- Unspecified amounts, New Generation, Gas Storage, Environmental Improvements, and CapX 2020.

In total, these additions add $1.8 billion[15] plus additional unspecified amounts to XEI's already large spending plan, including new expenditures planned for 2005-2009, with no additional source of internally generated funds for support. Note that none of the quantified amounts includes spending for a new base load generating resource to serve NSP's customers.

Notably, the rating agencies have concluded that internally generated funds will likely not be sufficient to cover these expenditures, even based on 2005 projections of capital spending. For example:

S&P: "On a consolidated basis [for Xcel and its subsidiaries], internally generated funds should cover around 85% of projected capital spending of $1.6 billion annually plus dividends through 2007. Increased cash flow resulting from the anticipated rate increases and declining spending in the later years should permit the consolidated company to internally fund 90% to 100% of capital requirements."[16]

Moody's: "Given the sizeable levels of Xcel's capital expenditures program, it is anticipated that in addition to internally generated cash, proceeds from remaining asset sales and NRG related tax benefits, ***Xcel will require external financing to complete these projects***" [17]

[15] These projects are shown in Exhibit MAM-5, page 4, as provided in an XEI slide presentation to investors in September 2006. Comparable commitments were confirmed in NSP's Non-Public response to Excelsior's Information Request 52.
[16] Standard and Poor's, Northern States Power Co., April 20, 2006.
[17] Moody's Investors Service, Analysis, Xcel Energy Inc., June 2005, emphasis added.

Q What do you conclude regarding NSP's risk exposure regarding its capital spending plans and requirements?

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

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

A As shown above, the capital spending required to complete construction of a base load plant by 2011 would add to NSP's and XEI's already full investment pipeline between now and 2011, and would likely require issuances of new debt and/or equity contributions from XEI. None of NSP's current plans includes spending for a base load 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

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

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

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

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

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

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

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

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

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

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

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

C. Regulatory Risks

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

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

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

A Regulatory treatment determines rates and the extent to which costs are recoverable from ratepayers. For a regulated utility generally, regulatory treatment is a primary factor in determining the extent to which future earnings and cash flows, which come from ratepayers, are likely to be sufficient to cover operating costs and debt service. As a result, from a bond holder's perspective, a "more favorable" regulatory climate is one where regulators provide greater certainty to bond holders regarding full cost recovery from ratepayers through rates, thereby reducing bond holder risks that rates will be insufficient to cover cost overruns (overruns in all cost categories, including capital expenditures, fuel and purchased power costs, labor costs 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.

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

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

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

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

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

Fitch: "Successful execution of XEL's core utility strategy *requires favorable regulatory actions*, including general *rate increases* and *allowances for cost recovery of specific capital projects*"[22]

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

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

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

> "*You've got to get the regulatory approval up front*. We have gone to the regulators and the state legislative body and have it written in law that *we're going recover our investment before we spend a dime*. We've got about $5 billion worth of projects that we're going to recover before we actually start spending the money."[24]

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

A Up front regulatory approvals for construction spending shift risks from bond holders and shareholders to ratepayers by reducing the risks to bond holder and shareholders of cost recovery disallowances resulting from future prudency reviews. For example, for NSP's MERP project and for PSCo's Comanche 3 project, ratepayers will begin paying currently for large capital projects that will not actually be in-service 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," Energy*Biz* Magazine, September/October 2006, p. 22

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

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

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

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

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

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

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

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

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

Q How do the rating agencies assess PPA risk?

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

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

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

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

A As described further below, the rating agencies' estimates of imputed debt and PPA risk for NSP for 2005 fall within a range, specifically, from zero to $401 million. S&P's estimate ($401 million[25]) is at the high end of the range and is not representative of the three rating agencies' assessments taken together. Moody's appears to assign very little or limited risk, and very little or limited imputed debt, to NSP's PPAs, and Fitch states that financial risk for NSP (as measured by imputed debt) is zero.

Q Please describe how <u>Moody's</u> assesses PPA risk.

A Moody's published criteria[26] are both qualitative and quantitative. Moody's criteria allow for cases where PPAs result in financial risk and imputed debt adjustments are appropriate, but any adjustments are contract and utility specific. Moody's states that "PPAs have a wide variety of financial and regulatory characteristics and are [sic] thus each particular circumstance may be treated differently by Moody's." Moody's goes on to state that PPA risk is measured along a "continuum", where at one end PPAs are considered as an operating cost and at the other end PPAs are treated as a debt obligation. Several qualitative factors are 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). .

- Risk management
- Pass-through capability
- Price considerations
- Excess reserve capacity
- Risk sharing
- Default provisions

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

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

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

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

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

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

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

[27]Moody's Global Electric Utilities. (emphasis added)
[28]Moody's Global Electric Utilities. (emphasis added)
[29]Moody's Global Electric Utilities. (emphasis added)
[30]Moody's Global Electric Utilities. (emphasis added)

- To provide certainty of supply
- To reduce balance sheet debt
- 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.

Q Does NSP presently have the ability to pass through the costs of purchasing power 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.

Q Please describe how <u>Fitch</u> assesses PPA risk.

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

- "Power purchase contracts are generally treated as an operating expense.
- <u>*On an exception basis*</u>, Fitch adjusts debt on the books of the buyer <u>*if*</u>:
  - Contract is for a long term, <u>*and*</u>

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

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

> "While XEL's subsidiaries have $6.5 billion in off-balance-sheet power purchase agreement obligations, the capacity payments associated with these agreements are mostly recoverable, and therefore, *no debt equivalency is assumed.*"[32]

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

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

In terms of financial risk, S&P views long-term PPAs with fixed capacity payments as creating a financial obligation for the purchasing utility which *can* have 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.

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

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

- "Buying power may be a more appropriate option for a utility than new plant construction because the utility avoids construction costs and the financial risks posed by regulatory lag when seeking recovery of costs."

- "Purchasing power may enhance supply flexibility, fuel resource diversity, and maximize load factors."

- "Utilities that plan to meet demand projections with a portfolio of supply side options also may be better able to adapt to future growth uncertainties."[34]

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

Q Please explain how S&P assigns a "risk factor" to PPA payments.

A S&P's determination of a risk factor is based primarily on its assessment of the 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

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

- "As a generic guideline for utilities with PPAs included as an operating expense in base tariffs, Standard & Poor's believes that a 50% risk factor is appropriate for long-term commitments. This risk factor assumes adequate regulatory treatment, including recognition of the PPA in tariffs; otherwise a higher risk factor could be adopted to indicate a greater risk of recovery."

- "For utilities in supportive regulatory jurisdictions with a precedent for timely and full cost recovery of fuel and purchased power costs, a risk factor of as low as 30% could be used."

- "In certain cases, Standard & Poor's may consider a lower risk factor of 10% to 20% for distribution utilities where recovery of certain costs, including stranded assets, has been legislated."

- "It is unlikely that no portion of a PPA would be capitalized (zero risk factor) under any circumstances."[36]

Q What risk factor has S&P assigned to NSP's PPAs?

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

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

A As described above, the level of regulatory and/or legislative assurances 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.

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

Q Could the risk factor be lower than 30%?

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

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

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

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

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

supply strategy,"[38] and *"No clear-cut formula can be followed in assessing the impact of third-party generation on an investor-owned utility's credit profile."*[39]

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

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

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

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

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

A The level of imputed debt assigned by the rating agencies, if any, to the Mesaba 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

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

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

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

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

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

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

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

Q How do you respond to Mr. Tyson's and Mr. Reed's claims that the specific terms of the Mesaba 1 PPA are "outside of industry norms" and "above market" and therefore the rating agencies will assign significant financial risk to the Mesaba 1 PPA?

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

E. Conclusions

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

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

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

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

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

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

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	*No utility capital investment required*	✓	
Risk of delays, cost overruns and performance problems	*Reduced or eliminated through PPA terms*	✓	
Risk of capacity shortfall	*Power delivered provides base load capacity*		✓
Risk of reliance on gas-fired resources	*Energy prices are based on coal*		✓
Financial risk due to PPA imputed debt, Mesaba 1	✓ *<u>BUT</u> substantially overstated by NSP/XEI <u>AND</u> can be minimized with regulatory assurances regarding cost recovery*		
Relative risk exposure	**Lower**	**Higher**	**Higher**
* Note that new base load capacity for MN is not included in NSP's current capital spending plan			

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

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

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

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

A No, neither qualitatively nor quantitatively.

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

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

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

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

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

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

published in a report titled, "Impact of Power Purchases from Nonutilities on the Utility Cost of Capital."[40] It concludes:

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

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

> "The data failed to support the hypothesis that utilities with significant power purchases incurred a higher cost of capital than the utilities without such a commitment. In fact, the evidence shows that utilities with little or no power purchase commitments had to bear a slightly higher cost of capital in comparison with the cost borne by the other group."[44]

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.

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

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

A I have never seen such a study.

Section 2.

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

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

A Yes. Mr. Tyson's primary conclusion in his testimony is that "The Mesaba 1 PPA would likely cause significant credit rating downgrades – possibly below investment grade,"[46] and this conclusion is based on a quantitative analysis included in his testimony.

Q Do you have any concerns with the quantitative analysis?

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

[45] Id., p. viii.
[46] Direct Testimony of George E. Tyson II, p. 2

Q What is your first concern?

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

Q What is your second concern?

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

Q What is your third concern?

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

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

Q What is your fourth concern?

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

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

[47] Mesaba 1 PPA, Schedule I.

of 7.22% in GET-1 Schedule 3 assumes a ten-year treasury rate of 5.2% to 5.39%, based on "a forecast of the applicable interest rate" between 2008 and 2010.[48] While interest rates do vary, 10-year treasuries have not been at or above 5.2% since April 2002 (excepting a two-week period in June 2006 where they reached 5.25%). Based on the average of daily ten-year treasury rates for the month of September 2006 of 4.7%, the Interest Rate Index Adjustment Factor would be 1.0176. Using an average of ten-year treasury rates over the past five years (4.4%), the Interest Rate Index Adjustment Factor would be 1.0. As shown in Exhibit MAM-7, where I have replicated the calculations used in Exhibit GET-1, Schedules 2 and 3, using an Interest Rate Index Adjustment Factor of 1.0176 results in a reduction in Mr. Tyson's imputed debt estimate of 5%.

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

Q What is your fifth concern?

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

[48] Direct testimony of Karen Hyde, p. 7

flexibility have long surpassed balance-sheet considerations as important rating factors.)"[49]

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

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

Q What is your sixth concern?

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

[49] Standard and Poor's, Corporate Ratings Criteria 2006, p. 77.

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

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

> "Unfortunately, *no clear-cut formula can be followed* in assessing the impact of third-party generation on an investor-owned utility's credit profile."[50]

Q What is your seventh concern?

A Seventh, the analysis concludes that the Mesaba 1 PPA could result in bond ratings below investment grade. Ignoring the fact that the analysis itself unreasonably overstates the impact of the Mesaba 1 PPA on bond ratings and credit quality, any bond rating for NSP or XEI below investment grade would be in large part due to the other current downward pressures on NSP's and XEI's bond ratings resulting from XEI's aggressive construction program and XEI's consolidated financial profile, as described in section 1 of my testimony. Unless these downward pressures are removed, it is inappropriate to assign the consequences of a non-investment grade bond rating to any single factor, and it is certainly not appropriate to assign the consequences solely to 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)

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

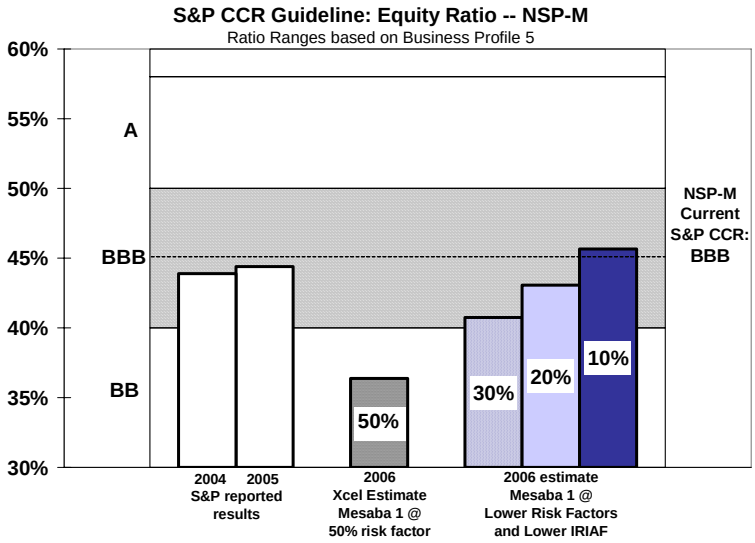
Q Can Mr. Tyson's quantitative analysis be corrected?

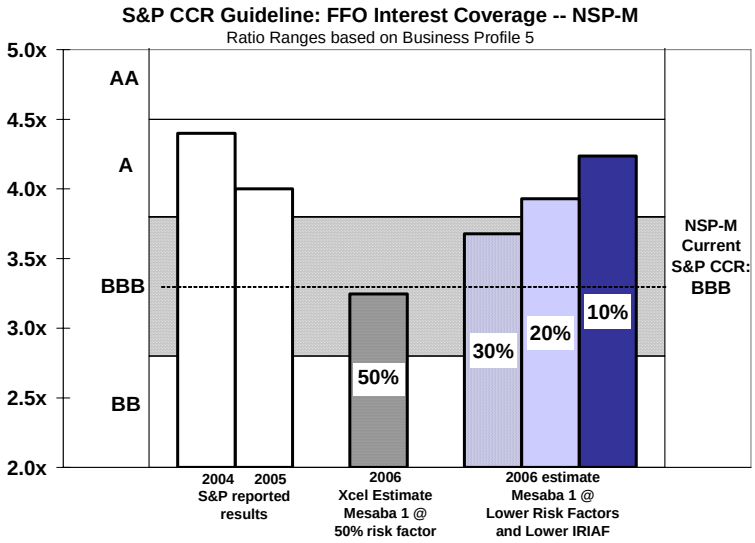
A Yes, but only in part. As described throughout my testimony, correcting the quantitative analysis is incomplete because it measures financial risk only, cannot capture the overall impact of the Mesaba 1 PPA on NSP's credit quality, and systematically overstates an adverse impact on credit quality.

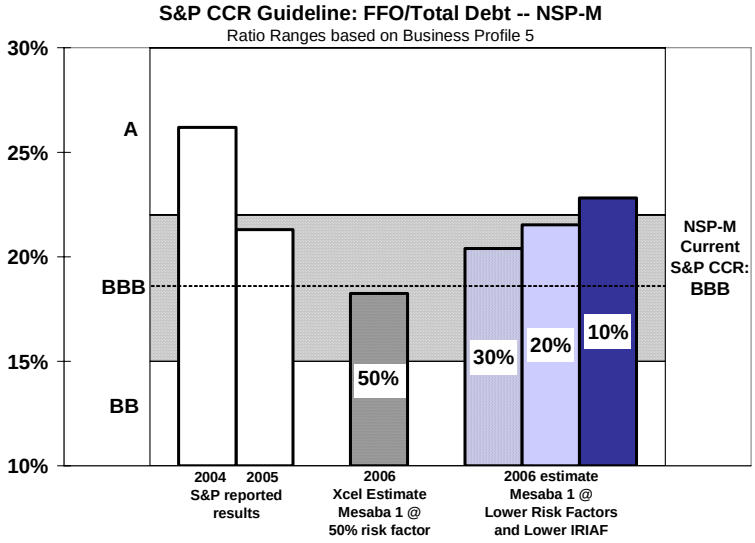
To correct Mr. Tyson's analysis at least in part, first and at a minimum, I use more reasonable estimates for S&P's risk factor, specifically 30%, 20%, and 10%, I use September 2006 ten-year treasury yields to project capacity payments under the Mesaba 1 PPA, and I evaluate results for all three of the metrics for which S&P publishes guidelines. Credit metric results with these adjustments relative to S&P's published guidelines for a Corporate Credit Rating[51] of BBB (NSP's current CCR) are shown graphically below, with detailed calculations shown in Exhibit MAM-9. These graphs show projected results compared to metrics reported by S&P for NSP for 2004 and 2005, and to Mr. Tyson's results. (NSP has had an S&P CCR of BBB since 2002). Based on these results, taking all three metrics together, NSP's metrics fall into the mid BBB range, even at my maximum recommended risk factor of 30%. Further, at a 30% risk factor, there is only a slight impairment in the three metrics from 2005 levels. These results show no likelihood that significant credit rating down grades would occur.

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

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





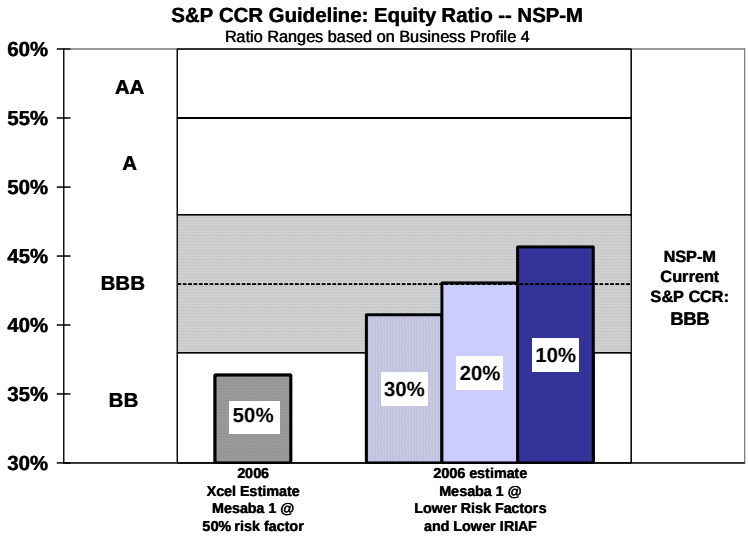


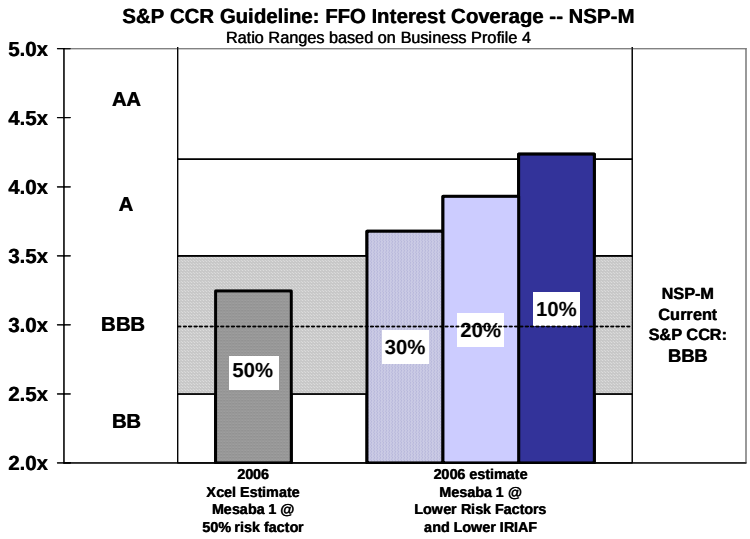
Q Can you make any quantitative adjustments to account for the reductions in risk that you have identified that offset financial risk?

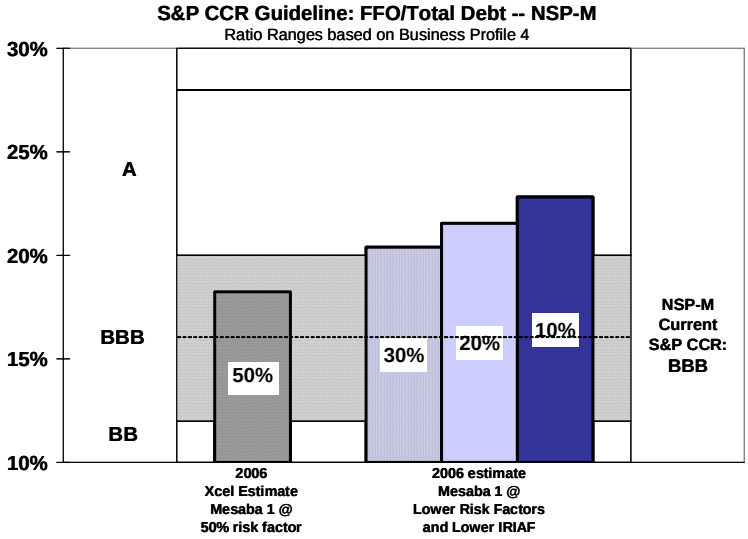
As a proxy for offsetting reductions in construction spending and capacity shortfall risks, I have also projected these credit metrics assuming an improved S&P business profile rating for NSP, from 5 to 4. At a business profile of 4, the benchmark

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

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







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

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

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

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

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

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

Section 3.

Mr. Tyson's assessment of the cost of credit quality impacts and the cost of remedies is flawed

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

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

Q Does Mr. Tyson provide estimates of these costs?

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

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

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

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

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

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

Note that higher bond ratings are not by definition "better" for a utility and its ratepayers than lower bond ratings, nor do they necessarily reduce overall cost of capital. If that were the case, all utilities would be striving for AA or AAA ratings, at a 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)

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

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

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

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

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

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

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

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

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

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

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

Q Mr. Tyson's testimony raises concerns about downgrades of <u>XEI's</u> bonds as the result of the Mesaba 1 PPA. Do you agree?

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

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

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

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

Q What cost recovery mechanism remedy does he consider?

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

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

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

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

Q What financial adjustment remedies does he consider?

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

Q Is this an appropriate adjustment?

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

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

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

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

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

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

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

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

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

Section 4.

Conclusions and Recommendations

Q Please summarize your conclusions.

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

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

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

Q Please summarize your recommendations.

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

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

b. find that the Mesaba 1 PPA reduces NSP's risks related to capital spending and capacity shortfalls, reducing any financial risk that may result due to imputed debt,

c. reject the use of S&P's imputed debt methodology as a measure of PPA risk and as a basis for capital structure adjustments,

d. find that as a result, the credit quality impacts of the Mesaba 1 PPA should not be addressed in this proceeding, and

e. find that to the extent that the Mesaba 1 PPA has an impact on NSP's credit quality, positive or negative, NSP will have the opportunity to request appropriate adjustments to its authorized capital structure and authorized return in the context of a future cost of capital proceeding, where all of the interrelated factors that impact the risk profile and credit quality of NSP are considered in total.

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

Q Have other jurisdictions rejected use of S&P's imputed debt formula to measure impacts on credit quality or otherwise determine appropriate "offsets" to compensate utilities for PPA risk?

A I am aware of cases in four states.

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

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

> "The [DPUC] can find no basis to select a formulaic aspect of one credit rating agency's [S&P's] business risk methodology and convert it into an inflexible cost to be recognized by regulators,"[54] and
>
> "S&P's method of imputing debt is merely one credit rating agency's attempt to assess the impact of long-term PPA/capacity contracts within a larger qualitative construct, and bears no relationship to the potential actual costs that electric distribution companies may experience as the result of entering capacity contracts."[55]

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

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

including the appropriateness of any risk factors used, the appropriate risk factor, and *the presence or absence of mitigating factors* shall be considered."[58]

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

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

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

Q Does this conclude your testimony?

A Yes, it does.

[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)