Surrebuttal Testimony
John J. Reed

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

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

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

PPA Risks and Financial Impacts

October 31, 2006

Table of Contents

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME.

A. My name is John J. Reed.

Q. HAVE YOU PREVIOUSLY PROVIDED TESTIMONY IN THIS CASE?

A. Yes. I provided Direct Testimony and Rebuttal testimony on behalf of Northern States Power Company d/b/a Xcel Energy ("Xcel Energy") regarding the Mesaba 1 PPA.

II. PURPOSE

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

A. I respond to the Rebuttal Testimony of Roger Gale, Edward Bodmer, Margaret Meal, Thomas Osteraas, and Renee Sass regarding PPA risks and financial impacts of the Mesaba 1 PPA.

Q. WHAT IS YOUR OVERALL ASSESSMENT OF THE REBUTTAL TESTIMONY FILED BY MESABA 1 LLC?

A. The Mesaba 1 LLC Rebuttal Testimony attempts to equate the Mesaba 1 PPA with PPAs in general, but does not address the effects of the *specific terms* of the Mesaba 1 PPA, which differ substantially from typical industry PPAs. The Mesaba 1 PPA (including the changes proposed by Mr. Osteraas) do not resolve the issues raised in my Direct Testimony regarding the transfer of risk from the project developers to Xcel Energy and its customers in key contract areas including: (i) Engineering, Procurement and Construction ("EPC")

costs; (ii) interconnection and fixed fuel costs; (iii) Operation and Maintenance ("O&M") costs; and (iv) timing of supply. As a result, my conclusions remain unchanged that the Mesaba 1 PPA would:

- impose excessive costs and risks on Xcel Energy and its customers;
- be very likely to adversely affect the credit rating of Xcel Energy; and
- be contrary to the public interest.

Q. PLEASE EXPLAIN HOW YOUR TESTIMONY IS ORGANIZED.

A. My Surrebuttal Testimony is presented in three additional sections:

- *Risk Allocation,* where I discuss why the Mesaba 1 PPA, even as amended by Mr. Osteraas, does not address the significant concerns regarding unacceptable risk transfers from the project developer to Xcel Energy and its customers.
- *Comparison to Self-Generation,* where I present how, contrary to Mesaba 1 LLC's assertions, the PPA imposes far more risk for Xcel Energy's customers than a self-build option poses.
- *Credit Rating Impacts,* where I describe the very real concerns about credit rating implications, contrary to Mesaba 1 LLC's assertions that they are exaggerated.

III. ASSESSMENT

A. Risk Allocation.

Q. DO YOU AGREE THAT THERE ARE NO APPLICABLE STANDARDS BY WHICH TO EVALUATE THE MESABA 1 PPA?

A. No. Mr. Gale states that Mesaba 1 LLC's needs are unique and outside the norm for "peaking and gas-fired intermediate plants" (page 3) and that the Mesaba 1 PPA should reflect those unique needs. While there are certain differences in terms that one would expect in a PPA for peaking plant versus a PPA for baseload generation, those differences do not justify the terms offered in the Mesaba 1 PPA or make the terms of typical PPAs irrelevant.

I also disagree with Mr. Osteraas statement that "there is no norm for large baseload solid fuel facilities" (page 17). To the contrary: (i) the size of a facility does not affect PPA fundamentals; (ii) there are relevant examples of power contracts for base load facilities; and (iii) while the facility's fuel may drive unique pricing terms specific to the fuel, this fact does not make acceptable the degree of project development and operational risk that Xcel Energy and its customers would be faced with under the Mesaba 1 PPA.

As discussed below, and more specifically in the testimony of Karen Hyde, EPC cost risk, heat rate risk, transmission costs, O&M costs, fuel cost risk and delay costs are all examples where the Mesaba 1 PPA imposes far more risk on Xcel Energy and its customers than typical PPAs.

Q. HAVE YOU PERFORMED AN INDEPENDENT ANALYSIS OF THE MESABA 1 PPA AND MESABA 1 LLC'S REBUTTAL TESTIMONY?

A. Yes. Mr. Osteraas' Rebuttal Testimony seems to suggest that my Direct Testimony was based on the analysis of the Mesaba 1 PPA performed by Ms. Hyde. To the contrary, both my Direct Testimony and this Surrebuttal Testimony are based on my independent analysis.

Q. HAS MESABA 1 LLC PROVIDED AN ADEQUATE RESPONSE TO CONCERNS ABOUT EPC COST CHANGES?

A. No. Mr. Gale points out that, under the Mesaba 1 PPA, construction cost risk is "only for a short period of time" (page 14), while Mr. Osteraas states that "it is a one time adjustment" (page 14), which he says is appropriate because "[n]o one can know today what the final construction cost for the facility itself will be" (page 15). However, it is not helpful that the risk is only for a short period of time or that there is only a one time adjustment because Mesaba 1 LLC is requesting approval *now*, *before* the time period runs and *before* the adjustment occurs.

Q. IS IT REASONABLE FOR XCEL ENERGY TO BEAR THE RISK OF INCREASES IN THE EPC CONTRACT COSTS UNTIL THE FINANCIAL CLOSE?

A. No. Messrs. Gale and Osteraas have missed the key point: it is premature to approve a PPA where the EPC costs are as lacking in certainty as in the Mesaba 1 PPA. The risk of EPC price changes is certainly not a risk that Xcel Energy should bear without strict limitations on those cost changes. Mr. Gale takes the opposite view on this issue (page 14) and offered Merrimack Energy Group's report to PacifiCorp from August 2006 as support for his position. Mr. Gale quotes from the report (page 15) regarding the suggestion by Merrimack that bidders in a competitive process be "allowed to bid capital cost components which include some indexing options," and Mr. Gale then asserts that "[t]his is precisely what Excelsior has done" (page 15). To the contrary, this is not what the Mesaba 1 PPA has done, and my review of the Merrimack report and discussion with its author show that Merrimack, in PacificCorp and other Requests For Proposals ("RFPs"), has been clear that

capacity prices need to be clearly specified, and offer the buyer significant price certainty.

Q. PLEASE ELABORATE.

For example, in a more recent Merrimack report on RFP standards to the Delaware Public Service Commission the recommendation is "that a portion of capacity price (no more than 15%) could be indexed to a steel index from the time of bid submission until the bidder executes its EPC contract but no later than two years after contract signing..., subject to a cap, and another portion could be indexed to general inflation or for labor costs to recover fixed operations and maintenance costs."[1] This approach, which has limited and capped escalation factors for both EPC costs and fixed O&M costs is far more predicable and appropriate than, and not at all similar to, the structure of the Mesaba 1 PPA.

Q. IS IT REASONABLE TO COMPARE THE EPC COST RISK IN THE MESABA 1 PPA TO THIS RISK IN A SITUATION WHERE XCEL ENERGY BUILDS ITS OWN PLANT?

A. Such a comparison is both complex and of little value. Messrs. Gale and Osteraas rely on the assertion that the EPC cost changes would be borne by Xcel Energy in a self-build option, but as discussed in Section B, the controls, oversight and alignment of interests are so fundamentally different in a self-build option as compared to a PPA structure that their assertion is invalid with regard to the risks customers ultimately bear.

[1] Final Report Regarding Delmarva Power & Light Company's Proposed RFP, October 12, 2006, Page 42.

Q. HAVE THE MESABA 1 LLC WITNESSES PROVIDED AN ADEQUATE RESPONSE TO CONCERNS ABOUT THE RISKS ASSOCIATED WITH OTHER CAPITAL COSTS?

A. No. Mr. Gale states that after financial close "all capital construction" costs are borne by Mesaba 1 LLC (page 14). However, for an undefined period of time thereafter, Xcel Energy will still be open to the risks stemming from transmission system upgrades and fixed fuel costs.

Q. HAVE THE MESABA 1 LLC WITNESSES PROVIDED AN ADEQUATE RESPONSE TO CONCERNS ABOUT O&M COSTS?

A. No. Although Mr. Gale claims that the Mesaba 1 PPA transfers all O&M cost risks to Mesaba 1 LLC, Mr. Osteraas acknowledges that both fixed and variable O&M costs are subject to change (page 28). This cost component remains open-ended and uncapped throughout the entire 25-year term of the Mesaba 1 PPA (reopening costs at five-year intervals throughout the term).

Q. HAVE THE MESABA 1 LLC WITNESSES PROVIDED AN ADEQUATE RESPONSE TO CONCERNS ABOUT FUEL MIX AND HEAT RATE?

A. No. The Mesaba 1 PPA offers no guaranty of the percent of time the Mesaba Unit 1 plant will run on solid fuel vs. natural gas, nor has Mesaba 1 PPA accepted Dr. Amit's proposal to allow operational flexibility to Mesaba but give economic assurance to Xcel Energy. Further, the Mesaba 1 PPA provides insufficient capacity payment credits when the plant is operated on natural gas, and provides no guaranty of the plant's heat rate. Since all fuel costs are passed-through on a dollar-for-dollar basis, there is no incentive for Mesaba 1 LLC to undertake the maintenance and on-going capital expenses to maintain a reasonable heat rate, or to control fuel costs.

Mr. Osteraas claims that Xcel Energy's customers have in the past assumed "unprecedented and extreme natural gas price volatility" and goes on to argue that those customers "should have no more or less fuel risk from the Mesaba 1 PPA" (page 26). I agree that the appropriate standard should be that customers should have no more risk than they would typically bear. However, in addition to imposing commodity price risk, the Mesaba 1 PPA does not guaranty the type of fuel that will be burned, the amount of fuel that will be burned (through a heat rate guarantee), nor does it sufficiently compensate Xcel Energy or its ratepayers for the lost value if what the customers are paying for (a state-of-the-art coal plant) is devalued because gas is substituted for coal.

In this regard, it is noteworthy that Mesaba 1 LLC did not respond to Dr. Eilon Amit's suggestion that the fuel cost be determined on the basis of a fixed mix of fuels as opposed to the plant's actual fuel mix.

Q. HAVE THE MESABA 1 LLC WITNESSES PROVIDED AN ADEQUATE RESPONSE TO CONCERNS ABOUT TIMING?

A. No. The timing of the Mesaba Unit 1 project is determined without regard or compensation for the impact on Xcel Energy or its customers. If Mesaba Unit 1 were to come on-line when projected, it would be well in advance of the Xcel Energy's need (as addressed by Xcel Energy witnesses Judy Poferl and Elizabeth Engelking). If Xcel Energy rebalances its portfolio in anticipation of the Mesaba 1 PPA deliveries, but the project is late, Xcel Energy and its ratepayers bear the burden with no compensation.

Q. DO YOU AGREE THAT THE USE OF NEW IGCC TECHNOLOGY MAKES TYPICAL PPA TERMS IRRELEVANT TO THE MESABA 1 PPA?

A. No. A change in technology may require some refinements to typical PPA terms but not an abandonment of risk allocation and cost responsibility fundamentals. As discussed in my Direct Testimony, there are good examples in the industry of managing risks for new technologies and executing PPAs (such as Ocean State Power when gas-fired combined cycle power was a new technology) that don't unduly burden utility customers. In addition, the contracting objectives of parties, such as UniStar Nuclear LLC, that are currently marketing new nuclear plants acknowledge the need for developers to manage the risks that buyers cannot, and should not, be expected to take, such as EPC cost risk and delay risks. These are real world examples of base load plants using new technology and managing costs and risks for buyers. Further, Wisconsin Energy's Power the Future Project ("Power the Future") shows that large (1230 MW) base load solid fuel facilities can be developed outside of a traditional utility rate base project on terms that don't subject customers to extreme risks.

Q. DID MR. GALE CORRECTLY CHARACTERIZE YOUR POSITION IN TESTIMONY BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION AND THE IOWA UTILITIES BOARD?

A. Yes. Mr. Gale extracted my comments on the two PPAs at issue in those proceedings as effectively shifting "to the maximum extent possible…operating risk, financial risk…industry risk…[and] potentially significant future capital expenditures," (page 12) to the power seller. He also pointed out my statements that fixed capacity and energy pricing for delivered

energy provides customers with a high-degree of certainty and very low exposure to operating risk (page 22).

Q. IS MR. GALE CORRECT IN CLAIMING THAT THE MESABA 1 PPA HAS SIMILAR CHARACTERISTICS?

A. No. Mr. Gale is completely wrong when he states that "[s]imilar terms in the Mesaba 1 PPA likewise offer the significant value of shifting risks away from Xcel Energy and its ratepayers" (page 22). The Mesaba 1 PPA is fundamentally different in structure and pricing than the Palisades and Duane Arnold Energy Center ("DAEC") PPAs that Mr. Gale refers to.

Q. PLEASE EXPLAIN HOW THE MESABA 1 PPA DIFFERS FROM THE DAEC AND PALISADES PPAS.

A. Since both DAEC and Palisades are operating nuclear units, I will focus on the differences that apply during the operating period. Fundamentally, the DAEC and Palisades PPAs are "pay for performance" contracts.[2] In any given month, if power is not delivered, the plant owner is paid nothing. All costs, including fixed costs are recovered by the owner on the basis of delivered energy. The Mesaba 1 PPA is fundamentally different from either of these PPAs.

Under the DAEC and Palisades PPAs, the owner is responsible for all capital, operating and fuel costs of the plant. Like the Mesaba Unit 1 project, the exact magnitude and timing of these costs is unknown and unknowable at this time. However, all of the capital costs will be borne by the new owner under

[2] The Palisades PPA is available in an unredacted form in the CMS Energy 10-Q filing dated August 4, 2006.

the DAEC and Palisades PPAs. None of them are passed onto the power purchaser, and the price per MWh delivered for all energy is fully specified in the PPA.

Additionally, the owner takes all responsibility for operating and maintaining the plant and purchasing fuel, with no "pass-through" mechanisms or reopeners. Both of these PPAs are for large, base load, solid fuel facilities. Each of them is an excellent example of risk shifting but bears no resemblance to the Mesaba 1 PPA.

Q. DO YOU BELIEVE THAT THE CONTRACT TERMS MR. OSTERAAS NOW PROPOSES TO CHANGE RESOLVE ANY OF THE KEY PROBLEMS WITH THE PPA?

A. No. The key flaws in the Mesaba 1 PPA boil down to an unspecified cost with no ceiling, no guaranteed performance level, and an all-in cost that is likely to be far above market. Mr. Osteraas' proposed changes do nothing to resolve these fundamental problems.

Q. DO YOU CONCUR WITH MR. BODMER THAT DR. AMIT HAS INCORRECTLY CALCULATED THE RELATIVE COSTS OF MESABA 1 PPA AS COMPARED TO OTHER ALTERNATIVES?

A. No. Dr. Amit's analytical framework is generally appropriate. While there may be certain data or assumptions that should be refined, Dr. Amit's use of Mesaba 1 LLC's model outputs as the basis of his analysis significantly favors the Mesaba 1 PPA. The understatement of the Mesaba 1 PPA costs that results from Dr. Amit's use of Mesaba 1 LLC model outputs far outweighs the impact of any adjustments that one might make to the economics of other resources.

Q. CAN YOU PROVIDE AN EXAMPLE OF THE MESABA 1 PPA COSTS THAT ARE UNDERSTATED IN THE DATA DR. AMIT USED?

A. Yes, as mentioned in my Direct Testimony, the economics of the Mesaba 1 PPA, as claimed by Mesaba 1 LLC, consistently exclude significant capital costs (the uncapped EPC contract adjustment, transmission costs, fixed fuel costs, etc.) and assume on-going performance that has no basis. These costs, which even Mr. Osteraas calls "significant" (page 15), are assumed to be zero in the analysis performed by Mesaba 1 LLC. Dr. Amit's analysis used the only information that was available to him, and demonstrates that even when the Mesaba 1 PPA is viewed in this most favorable light, it is grossly uneconomic.

B. Comparison to Self Build

Q. WHAT IS MESABA 1 LLC'S POSITION REGARDING THE RISK OF PPAS VS. UTILITY SELF BUILD?

A. Mr. Osteraas claims that "any power purchase agreement...contractually transfers risk *away* from the utility and its customers" (page 8). Mr. Gale refers to PPAs as being "inherently" less risky than utility ownership (see pages 2, 8, 10 and 24).

Q. DO YOU AGREE?

A. No. Any such "inherent" characteristic can clearly be undone by using non-standard terms in a PPA, as Mesaba 1 LLC does. In addition, such a risk assessment needs to consider that virtually all PPAs *create* some risks that are not present in a self-build option. For example, counter-party credit concerns and the loss of optionality are risks created by a PPA structure. The relative

risk to ratepayers depends on the specific terms of the PPA. As noted above and as demonstrated by the DAEC and Palisades PPAs, the economic exposure under the Mesaba 1 PPA is orders of magnitude greater than the risks in either of those PPAs. Accordingly, it is not meaningful to judge the appropriateness of Mesaba 1 LLC's proposed terms by simply looking at generic attributes of PPAs.

Q. WHAT ARE THE KEY DIFFERENCES BETWEEN THE UTILITY SELF-BUILD OPTION AND TYPICAL PPA STRUCTURES?

A. I would generally describe the key differences as: (i) a change in the alignment of interests; (ii) a change in the role of regulatory oversight; and (iii) the creation of counter-party and contractual risks. Once a PPA is signed, the power seller typically has little or no need to be concerned about the costs and risks that are imposed on the buyer's customers. A seller under a PPA is only required to meet the terms of the contract, not a broader standard of charging just and reasonable rates or providing customer benefits, subject to regulatory oversight.

Q. CAN YOU OFFER SOME EXAMPLES OF HOW THESE DIFFERENCES AFFECT RISKS?

A. Yes. Mr. Osteraas claims that the EPC cost risk in the Mesaba 1 PPA is lower than the risk of self-build because, once the EPC cost is fixed in the Mesaba 1 PPA, Xcel Energy is no longer subjected to cost overrun risk. However, the total level of the EPC cost and the amount of contingency that will be included in the lump-sum turn-key price are outside of Xcel Energy's and the Commission's control. Once the Mesaba 1 PPA is executed and approved, there is no motivation for Mesaba 1 LLC to control EPC costs or limit the contingencies that the EPC contractor will include, and neither Xcel Energy

nor the Commission have any control or review authority over Mesaba 1 LLC's actual costs. Conversely, in a self-build scenario, Xcel Energy remains subject to on-going prudence reviews of all costs and is subject to disallowances if its decisions are imprudent, unreasonable or wasteful.

In the portion of the Merrimack report provided by Mr. Gale, Merrimack states that passed-through price changes "[i]deally...would be controlled by performance incentives" (RWG-6, page 38). These protections are not included in the Mesaba 1 PPA.

Another example Mr. Osteraas uses is the fuel risk (page 26) that he considers to be the same under the Mesaba 1 PPA and an Xcel Energy-build option. However, with the Mesaba 1 PPA's: (i) absolute pass-through of costs, (ii) no guarantee of heat rate, and (iii) limited capacity charge relief if Mesaba Unit 1 ends up burning natural gas, the Mesaba 1 PPA offers no protection to Xcel Energy or its customers, and no risk to Mesaba 1 LLC. Further, under an Xcel Energy-build option, fuel costs and use are subject to an ongoing regulatory review.

Mr. Gale states that the Mesaba 1 PPA protects ratepayers because "payments are only made under the Mesaba 1 PPA for capacity actually available" (page 21). In fact, the PPA requires Xcel Energy to make capacity payments on the basis of Net Capability at Reference Conditions (Mesaba 1 PPA page 12, definition of Net Capability). Depending on the ambient conditions, the operations and maintenance of the plant over 25 years and the fuel Mesaba 1 LLC chooses, the actual available capacity could be 17% less than the amount

the capacity on which the payment is based.[3] The Mesaba 1 PPA again insulates Mesaba 1 LLC from any cost consequences of the Mesaba Unit 1 project not performing well under real operating conditions, since the capacity payment does not change based on actual generating capability. Conversely, under the self-build option, Xcel Energy would expect that on-going prudence reviews by the Commission would protect customers if poor decisions by Xcel Energy were to lead to the plant performing poorly.

These same basic principles of economic immunity under the Mesaba 1 PPA vs. on-going cost responsibility under the self-build option apply to O&M costs, transmission costs, and fixed fuel costs, among others.

C. Credit Rating Implications

Q. HOW DO YOU RESPOND TO MR. GALE'S ASSERTION THAT YOUR CONCERNS ABOUT IMPUTED DEBT ARE "EXTREME AND MISLEADING" (PAGE 9)?

A. I disagree. These risks are very real and have been convincingly demonstrated by a number of companies. The negative effect on a company of poor credit ratings can and has led to an inability to raise capital, inability to perform and in some cases bankruptcy. The best approach to these risks is to not try to compensate a company for these risks, but to avoid them.

Q. DO YOU AGREE WITH MR. GALE'S ASSERTION THAT RATING AGENCIES' CONCERNS WILL BE FULLY RESOLVED IF THE COMMISSION INDICATES IT WILL APPROVE XCEL ENERGY'S COST RECOVERY FOR THE MESABA 1 PPA COSTS?

---

[3] See Mesaba 1 PPA, Exhibit G, page 3, noting that Mesaba Unit 1 will provide 503 MW (natural gas) vs. 603 MW at Reference Conditions.

A. No. Rating agencies are keenly aware that decisions of one commission are not binding on future commissions. Accordingly, the rating agencies look beyond an initial regulatory approval of cost pass-through to customers and review the fundamental economics in order to determine the risk level associated with any particular contract. To the extent that a PPA is above market or provides pricing that is outside of market projections, rating agencies consider the risks associated with that PPA to be increased. In part this is because of the increased likelihood of such a PPA later being rejected by a commission or becoming the subject of litigation between the parties. Rating agencies also carefully evaluate the risk allocation in a PPA, and whether the power is needed when they consider the rating impacts. The Mesaba 1 PPA fares very badly on both of these points.

Additionally, the Mesaba 1 PPA does not meet the thresholds Mr. Gale sets out in his testimony. He states that rating agencies are not concerned if "the PPA assures that the project failure risk is largely held by the developer" (page 11). Mr. Gale does not define "project failure" but total cost, capacity factor, fuel choice, heat rate, and on-line date are all factors that can contribute to economic project failure. Those risks are not borne by Mesaba 1 LLC, as a developer, but rather, are largely borne by Xcel Energy and its customers under the Mesaba 1 PPA.

Q. DO YOU HAVE OTHER CONCERNS WITH MR. GALE'S POSITION?

A. Yes. His statement that Xcel Energy "has no grounds for opposing the Mesaba 1 PPA" if there is an assurance of full pass through of costs to ratepayers ignores the fundamental duty of a public utility, i.e., to provide service at just and reasonable rates.

Q. DO THE SOURCES THAT MS. MEAL CITES SUPPORT HER CONCLUSION THAT RATING AGENCIES WILL RESPOND FAVORABLY TO THE MESABA 1 PPA?

A. No. To the contrary, her testimony underscores the concerns that rating agencies will have concerning the Mesaba 1 PPA. Throughout her testimony Ms. Meal cites rating agency publications about PPAs, based on generic PPA structures. Such a general discussion does not resolve the issue in this case, which will be based on the specific terms of the Mesaba 1 PPA. My Direct Testimony and the Direct Testimony of Ms. Hyde demonstrate the numerous ways in which the Mesaba 1 PPA diverges from typical PPA terms.

Q. MS. MEAL ALSO CITES TWO STUDIES FROM 1994 CONCLUDING THAT PPAS HAVE NOT BEEN SHOWN TO ADVERSELY AFFECT A UTILITY'S DEBT COST. (PAGES 38-39) HOW DO YOU RESPOND TO THESE STUDIES?

A. The importance of PPAs to a utility's debt rating has changed dramatically since 1994, which was before rating agencies developed a specific focus on the debt equivalence of PPAs. Rating agency statements also have an effect on the cost of equity, so those studies are not representative of current conditions.

Q. MS. MEAL ALSO CITES FROM FOUR UTILITY COMMISSION ORDERS THAT SHE CLAIMS SHOWS THAT OTHER COMMISSIONS HAVE REJECTED THE STANDARD & POORS DEBT IMPUTATION METHODOLOGY WHEN CONSIDERING THE EFFECTS OF PPAS (PAGES 61-63). HOW DO YOU RESPOND TO THESE STATEMENTS?

A. Three of the four commissions that Ms. Meal cites have affirmed that they *do* include imputed debt as one of the considerations in evaluating the costs imposed by PPAs. In a more recent document, the Utah Division of Public

Utilities has called for PacifiCorp to secure an advisory ratings opinion so that these impacts can be included in the final RFP evaluation. Florida and California, two other states cited by Ms. Meal, specifically have acknowledged the importance of considering the debt equivalence issue in RFP evaluations. In addition, there are several other Commissions that she does not cite that also support the approach I have recommended. There is no question that, taken as a whole, utility regulators clearly understand the importance of imputed debt in evaluating PPAs.

Q. ARE THERE SPECIFIC PROVISIONS THAT RATING AGENCIES LOOK FOR IN PPAS WHICH MESABA 1 PPA DOES NOT PROVIDE?

A. Yes. For example, Ms. Meal indicates (pages 24 – 25) that Moody's views PPAs generically as providing a risk reduction if the following features are present:

- *Outsourcing of operating risk:* While a standard PPA may do this through fixed operating costs and performance guarantees, the Mesaba 1 PPA offers no such protections, but rather subjects the buyer to uncapped costs with no performance thresholds.
- *Certainty of supply:* Again, while this is typical for PPAs, this benefit is not provided in the Mesaba 1 PPA,
- *Fixing the cost of power:* While price certainty is a valued feature of many PPAs, the Mesaba 1 PPA does not have any certainty at this time or even a ceiling on the capacity, energy, or O&M costs.

Ms. Meal also points out that Fitch assesses PPAs' risks based in part on the need for power. Additionally, Fitch adjusts debt if the contract is "for a long term *and* the price is above market" (pages 25-26). Xcel Energy has

demonstrated that the Mesaba 1 PPA would provide power in 2011, which is in advance of the need. Further, there is no doubt that 25 years is a long-term contract and that the cost of power from Mesaba Unit 1 (viewed in the most favorable possible light) is well above market. Using the standards that Ms. Meal cites, Xcel Energy is at significant risk of an adverse rating agency response to the Mesaba 1 PPA.

Q. SHOULD THE COMMISSION DEFER CONSIDERATION OF THESE ISSUES UNTIL A FUTURE RATE CASE?

A. No, it would be inappropriate to defer this issue, which is a key element to assessing the overall ratepayer impact of the Mesaba 1 PPA. By the time of the next rate case, the impacts on the cost of capital, credit rating impacts and obligations on Xcel Energy and its ratepayers would have already been incurred. To prevent incurring unknown costs and risks, the expected impact must be reviewed and understood *now, before* the Mesaba 1 PPA costs are imposed on Xcel Energy and its customers. Once the Mesaba 1 PPA is signed, there is no way to undo the risk and the cost of capital impacts.

Q. DO YOU BELIEVE THAT AN ADVISORY RATING SHOULD BE USED TO CONFIRM THE IMPACT?

A. Yes. Ms. Sass' concerns about this approach do not provide any basis not to invoke this valuable tool for development of important information. The rating agency review does not rest on Xcel Energy's assessment of the Mesaba 1 PPA (page 2), but rather on the agencies' assessment of the document itself. Further, Ms. Sass's reluctance to undertake such a review because the terms and conditions of the PPA are not yet finalized (page 3)

seems inconsistent with Mesaba 1 LLC's position that the Mesaba 1 PPA, as amended by Mr. Osteraas, is appropriate for adoption by the Commission.

IV. CONCLUSION

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS REGARDING THE RISKS AND FINANCIAL IMPACT OF THE MESABA 1 PPA ON XCEL ENERGY AND ITS CUSTOMERS

A. The Mesaba 1 PPA, as amended by Mr. Osteraas, is not in the public interest and should not be approved. Contrary to the terms of typical PPAs, the Mesaba 1 PPA, as amended, would continue to impose on Xcel Energy and its customers nearly all of the risks relating to:

- construction,
- operations,
- fuel costs,
- delivery/transmission capital costs, and
- performance.

In my opinion, these shifts in risk are completely inappropriate and contrary to the pubic interest.

The Mesaba 1 PPA, as amended, will be likely to have severe adverse impacts on the credit rating and cost of capital of Xcel Energy. Contrary to the witnesses for Mesaba 1 LLC, assurances of cost recovery will not resolve all concerns of either Xcel Energy or the rating agencies. Waiting until a future rate case to address these impacts is inappropriate because the approval of the

Mesaba 1 PPA and resulting damage will have been done by that time, with no possibility of correction.

Because of the enormity of this commitment, the resulting debt consequences and ratepayer costs should be fully known before the Mesaba 1 PPA is found to be in the public interest. Therefore, before making any final decision to proceed, I continue to recommend that the Commission require that preliminary credit ratings be obtained.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.