



January 5, 2007

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

Dear Judges Mihalchick & Johnson:

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

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

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

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

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

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

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

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

A Mesaba fixed price contract should include all of the costs of delivering electricity to Xcel Energy's customers. Specifically, the all-inclusive price should include the capacity and energy costs, all operation and maintenance costs, all transmission and ancillary services costs, and the

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costs of capturing and then sequestering no less than 90 percent of the facility's carbon emissions.

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

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

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

While an all-inclusive fixed price provides significant ratepayer protections, Commission-approved PPAs also include other reasonable protective contract provisions. The most important protections deal with instances where the contracting energy provider cannot or does not perform. Such non-performance issues arise in two instances. One is when the facility does not get built and, therefore, never provides any electricity. Another instance would be where the project is built but there are operational problems that prevent it from providing electricity for a

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significant amount of time. Besides having adverse consequences for the contracting facility, ratepayers are harmed because the utility, on behalf of those customers, often has to acquire electricity to replace the electricity the facility was supposed to provide, often at a higher cost than the PPA price. The Mesaba PPA should be modified to incorporate these kinds of non-performance protections.

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

Sincerely,



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

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