Minnesota Public Utilities Commission
Staff Briefing Papers

Meeting Date: December 19, 2013 .... **Agenda Item **#9**

Company: Xcel Energy (Xcel or the Company)

Docket No. **E-002/M-00-1583**

In the Matter of the Request of Northern States Power Company d/b/a Xcel Energy for Approval of a Renewable Development Oversight Process

Issues: Should the Commission find that the costs of the Ecovation f/k/a AnAerobics, Inc. (AnAerobics) Cycle 1 Renewable Development Fund (RDF) project were not prudently incurred?

Should the Commission require Xcel to return to the RDF fund, and credit to ratepayers, the amount of $1.1 million expended in 2003 on the AnAerobics project?

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Relevant Documents

PUC Order, in Docket E-002/M-00-1583..issued August 17, 2004
Xcel status update on Ecovation f/k/a AnAerobics. ....August 8, 2013
Department comments. ....October 2, 2013
Xcel reply...November 8, 2013
Department response..November 20, 2013

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Statement of the issue

Should the Commission find that the costs of the Ecovation f/k/a AnAerobics, Inc. (AnAerobics) Cycle 1 Renewable Development Fund (RDF) project were not prudently incurred?

Should the Commission require Xcel to return to the RDF fund, and credit to ratepayers, the amount of $1.1 million expended in 2003 on the AnAerobics project?

Background and parties' arguments

On August 8, 2013, Xcel filed a status update on the development of replacement projects for the AnAerobics RDF project equipment pursuant to the Commission's *Order Deferring Decision, Allowing Time to Develop Alternative Uses, and Requiring Consultation and Report,* in Docket E002/M-00-1583, issued August 17, 2004. The Ordering Paragraphs are as follows:

1. The Commission will grant Xcel's request and defer decision on the issue of disallowance of project costs to a later date.

2. Within 90 days of the August 5, 2004 hearing on Xcel's request, Xcel shall report back in writing on the development of replacement projects for the AnAerobics RDF project equipment.

3. During the 90-day period described in Order Paragraph 2, Xcel shall also work with the Department, the Renewable Development Fund (RDF) Board, and the Commission staff to develop recommendations that address the concerns raised by the Department and Commission staff, including RDF administration and Board membership.

4. At the end of the 90 day period described in Order Paragraph 2, Xcel shall submit (in conjunction with the filing made pursuant to Order Paragraph 1) recommendations on how these concerns might be addressed.

During the first RDF funding cycle (Cycle 1), AnAerobics submitted a proposal for the development of a food biomass project in Montgomery, Minnesota. On March 5, 2002, Xcel and AnAerobics executed an RDF grant contract for the design, procurement, and installation of electrical generating equipment for the biomass project. Following approval of the contract by the Commission, AnAerobics commenced work on designing and procuring the facilities necessary for the project.

On April 8, 2003, AnAerobics notified Xcel that it was suspending work on the project due to the potential termination of its relationship with the project host, Seneca Foods. The terms of the grant contract between Xcel and AnAerobics still required payment for the completed milestones.

On June 5, 2003, the RDF Board met to discuss the work suspension and payment to AnAerobics for attainment of the completed milestones. Following this meeting and verification by Xcel that the requisite electrical equipment was physically at the Seneca Foods plant and was being properly protected, Xcel paid AnAerobics $1.07 million on June 10, 2003 for completion of contract milestones 2, 3, and 4. In a letter dated July 22, 2003, AnAerobics formally notified Xcel that its relationship with Seneca Foods was terminated.

Following termination of the relationship between AnAerobics and Seneca Foods, the RDF project ended and the two generators were never installed. Xcel took possession and title to the two generators in July 2004. In comments filed on March 30, 2004 in the 2003 annual automatic adjustment (AAA) report docket, the Department recommended that the Commission disallow recovery of AnAerobics' dispersed grant costs of $1.07 million.[1]

Xcel responded to the DOC's concerns in filings on April 15, 2004 and July 21, 2004 in RDF Docket 00-1583. In these filings, Xcel explained that it was legally obligated to pay the funds to AnAerobics under the contract and that there was no legal basis for Xcel to recover the costs of the equipment.

On August 4, 2004, Xcel filed a letter in the RDF docket requesting that the Commission defer action on this matter to allow the Company the time to find other applications for the two purchased generators, thereby recouping for ratepayers some value of the original grant. In an August 17, 2004 Order, the Commission deferred its decision on the issue of disallowance of the dispersed grant funds to a later date to allow Xcel the opportunity to repurpose the two generators. From 2004 until June 2013, Xcel was unable to find buyers for the two generators, and no action was taken on the decision to defer grant funds.

In June 2013, Xcel located a buyer, Net Distributed Power, LLC (NDP), for the Kohler 600 kW generator. Xcel entered into a Purchase and Sales Agreement with NDP on June 17, 2013 to sell the Kohler generator for $50,000. The purchase price is within the range of appraised value for this generator of $25,000 to $75,000 based on a 2008 valuation obtained by Xcel.

As of the date of Xcel's status report filing, the Company was in negotiations with Sanimax, Inc. to sell the Waukesha generator for use in Sanimax's biomass operations.[2] The Company believes that the recent purchase agreement for the sale of the Kohler generator is in the public interest and the $50,000 sales price is in line with the appraised value of this generator. The proceeds from this sale will also recoup a portion of the RDF funds disbursed to acquire this generator.

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[1] See Docket No. E,G-002/AA-03-1264.

[2] Xcel updated staff to indicate that the second 1100 kW Waukesha generator set has been proposed to be put into service as part of an RDF Cycle 4 proposal submitted by SGE Partners (EP4-4). The proposal would utilize this generator set at an anaerobic biomass facility to be installed at Sanimax (located in South St. Paul). The project has been recommended by Xcel for a Cycle 4 grant award. Therefore, the status of the second generator is pending Commission approval in the RDF Cycle 4 selection of projects. Xcel indicated that the use of the generator set by Sanimax will be similar to the original intent of the AnAerobics project and that the benefits to ratepayers will also be similar.

While Xcel acknowledged that the sale and repurposing of the two generators will not recoup the remaining $1.07 million of RDF funds expended by ratepayers, it noted that the untimely termination of the AnAerobics project did provide the Company with valuable insights on ways to improve administration and oversight of RDF projects. These include learning that the RDF grant contract must have terms that increase the likelihood that the grant recipient obtains all necessary components for successful completion of an RDF project.

Another lesson from the AnAerobics project was that project milestones and grant payments in the energy production grant contracts should be structured to provide payments upon project completion rather than completed interim tasks to support a project's cash flow needs. While the termination of the AnAerobics project was unfortunate, the Company argued both in 2004 and in the current proceeding that no disallowance is necessary.

On October 2, 2013, the DOC filed comments disagreeing with Xcel that no disallowance is necessary. The DOC repeated arguments from 2004 that the Company had not acted prudently in the contract management and administration of the AnAerobics RDF grant contract, and that loose contract management was compounded by Xcel's lack of transparency and selective treatment of the Commission-approved grant contract provisions.

On November 8, 2013, the Company replied that project termination is a rare but inevitable result of an organization whose mission is to promote the start-up, expansion and attraction of renewable energy projects. The Company cited the Commission's *Order Adopting Process and Operational Improvements, Ending Time Restriction on Administrative Expenditures, and Requiring Further Filings*, in the RDF Docket No. E-002/M-00-1583, issued October 5, 2006, in which the Commission concluded that there was no need to substitute an alternative structure for the RDF process:

> There is no pressing need to substitute a different administrative structure for the current one. The current structure has supported two funding cycles, facilitated the distribution of over $39,000,000, and jump-started over 40 renewable energy projects. Only one project, the AnAerobics project, is claimed to have gone seriously awry. And while the Commission has yet to make a determination on that claim, it would not be fatal if true, since failed projects are a legitimate and inevitable part of any systematic program to fund emerging technologies.

On November 20, 2013, the DOC filed comments continuing to argue for disallowance of the $1.1 million in ratepayer funds, based on Xcel's imprudent oversight of the original contracting process.[3] The DOC cited loose contract management, avoidable risks, lack of due diligence over Seneca Foods, lack of transparency, lack of appropriate review and inadequate legal enforcement of its contracts with AnAerobics.

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[3]The original RDF grant award to AnAerobics was $1.3 million. Of this total, $200,000 was never dispersed to AnAerobics. Therefore, the DOC recommended that the Commission require Xcel to return $1.1 million to the RDF tracker, while allowing the Company to keep any proceeds from the sale of the generator equipment.

Staff discussion

Almost 11 years have passed since the issues in this case were brought to the Commission. Consistent with its 2004 Order, the Commission is now being asked to approve the sale of the equipment and to make a final determination on the recovery of the expended funds.[4] Staff notes that the Commission's deferral of the decision to disallow was not a denial of the recovery of these costs. Now Xcel has found a buyer for the generation equipment, thereby recouping for ratepayers at least some of the value of the original RDF grant consistent with the findings and conclusions of the Commission's Order in this matter (Order issued August 17, 2004, in 00-1583).

Since 2004, Xcel has experience very few projects that did not proceed to conclusion.[5] As noted by Xcel in its November 8, 2013 reply comments:

> This AnAerobics project was selected and approved during our first RDF cycle, over 11 years ago. The project involved cutting edge technology and we provided flexibility to the vendor to enable them a better chance at success. Since the termination of the AnAerobics grant contract, we have implemented several processes and management tools to better control the risks associated with these RDF projects for our customers. In addition, we made extensive efforts to recoup some of the costs spent on two generators for this project by trying to sell the generators or finding a comparable project that could use the generators.
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> The mission of RDF is to promote the start-up, expansion and attraction of renewable energy projects. Thus, we fully anticipate that some of the projects selected for funding will not be successful due to the very nature of their innovative technology. That said, we acknowledge that process and management improvements were needed for the RDF program. Ultimately, this project did not succeed because of the technology and methods our vendor employed, not because of contract mismanagement. Unsuccessful projects are rare and we are proud of our RDF program and the many achievements we have had as a result of it. We look forward to future successes within our RDF program and a swift resolution of issues related to this unique project.

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[4] On November 13, 2013, Xcel explained to staff that the buyer for the 600 kW generator indicated it would not follow through with the purchase if the sale was not closed by the end of 2013. The buyer's obligation to purchase the 600 kW Kohler generator set is contingent on regulatory approval. However, the purchase agreement does not explicitly address how long the contract is valid for or what options either party has in cancelling the agreement other than for failure to pay, failure to pick-up the equipment and standard regulatory approval contingency.

[5] In the Legislative Auditor's Evaluation Report of the RDF Fund (October 2010), the Auditor detailed the project histories in Cycles 1, 2 and 3, and noted improvements over the course of these RDF Cycles. (See Report Appendices B and C. pp. 63-74). In general, the Auditor's Report was supportive of the RDF process. Also, Xcel noted that, across the three funding cycles, only three other RDF projects did not proceed to conclusion.

The Department's comments in this matter carefully and accurately restate the arguments made by the DOC and Commission staff in 2004.[6] However, it is difficult to reconstruct the full set of arguments in favor of and opposed to the disallowance of funds as presented in 2004. Moreover, simply rearguing the case as of 2004 does not reflect what has happened since, including: (1) a decision from the Commission based on the complete record in 2004 to defer disallowance to a later time, (2) the passage of almost 11 years, and (3) as a direct result of the Company's experience, significant changes and improvements in Xcel's administration of the RDF program.

Improvements and lessons learned since 2004

The Commission now has the advantage of being able to evaluate the effects of the AnAerobics project on Xcel and the Company's administration of the RDF process. In reply comments, Xcel acknowledged the impact that the project termination had on risk management for its customers in the context of the RDF fund:

> As discussed in our August 8, 2013 Status Update, we learned a number of lessons during the first RDF funding cycle, including lessons from the AnAerobics project. The same can be said for each of the funding cycles, and with these lessons come improvements in the process. We have worked hard to improve the RDF program and tighten our project and contract management. For example, RDF administrative and contractual improvements were put into effect in Cycle 2 and have evolved in subsequent cycles (i.e. lump sum payments, standardized contracts, project reporting requirements, etc.). We believe the improvements we now have in place will better manage risks for our customers.
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> As a result of the Commission's August 17, 2004 Order, the Company engaged in a series of stakeholder meetings with Department of Commerce, Commission staff, and representatives of the RDF board. These stakeholder meetings ultimately culminated in a series of Commission Orders in this docket, dated August 3, 2005 and October 5, 2006, which fleshed out the operation and administration of the RDF. Improvements to the RDF during the years following the AnAerobics contract termination include the following:
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> - Authorization to use no more than five percent of grant funds to develop, administer, monitor, and evaluate grant contracts;
> - Requirement to file Quarterly Reports with the Commission to keep stakeholders informed as projects progress;
> - Requirement to publish on its website information about the Projects funded by the RDF; and
> - Development of the RDF's mission statement.

[6] See Department comments filed on October 2, 2013 and November 20, 2013, in the current docket (00-1583).

Xcel noted that these improvements and lessons learned were facilitated by the careful analysis and work of the Department. The Department's initial discovery, development and analysis were a catalyst for the change and improvements to the RDF program. Research and Development (R&D) projects by their nature have the potential to encounter unforeseen difficulties. In retrospect, the fact that to date the Cycle 1 AnAerobics project is among only a few projects to terminate prior to completion is largely due to the oversight of Xcel, the Department, and the RDF Board.[7]

Reasons for the delay of sale of the generation equipment

Part of the explanation for the long deferral period was the difficulty in finding a buyer for the two fuel generators. Xcel explained its efforts to find a use for the generation equipment as follows:

> The Company's resale efforts include issuance of Formal Notices of Opportunity in 2005 and 2009. The 2005 Notice of Opportunity was sent to over 700 potential bidders, but did not result in a feasible proposal. In 2009, a Notice of Opportunity was sent to 317 vendors that were targeted as entities that have some form of involvement in anaerobic digestion, methane utilization, biomass, and energy production. The 2009 Notice of Opportunity resulted in four proposals for the Kohler generator, but none of these proposals resulted in a sale.
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> There have also been prospects outside of a Formal Notice of Opportunity. In 2007, the Kohler generator was included as an option for a Cycle 3 proposal (RD3-16) submitted by AURI that would install and demonstrate biomass gasifier at the Polaris facility in Roseau, Minnesota. Ultimately, this RDF bid was not considered as an option due to its bid score. The generators were also posted on a website for surplus equipment by the Company's Investment Recovery group in 2012. [See Xcel's status update, p. 6, Docket No. 00-1583, filed August 8, 2013.]

Xcel explained further:

> There was significant time and effort expended to identify an appropriate and comparable project for the equipment that was repossessed upon the dissolution of the AnAerobics project. As discussed in our August 8, 2013 Status Update, over the years, filings specific to the disposal of the AnAerobics equipment and the quarterly RDF progress reports have informed the Commission of many of Xcel Energy's activities to recoup losses related to this project.
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> In addition, numerous informal inquiries through networking with stakeholders have been pursued. Unfortunately, these information inquiries did not work out for a variety of reasons including the fact that these two biogas fuel generators are specialized and there

[7] The AnAerobic's project is one of 72 RDF projects awarded a grant in the first three cycles. Total funding awarded to these projects was $77.8 million.

> are a limited number of buyers. [See Xcel's reply comments, p. 5, Docket No. 00-1583, filed November 8, 2013.]

Reporting and updates from Xcel

Xcel's August 8, 2013 status update in this docket detailed the extensive background of the AnAerobics project as well as Xcel's regular reporting on this issue. Since 2004, the Company has reported on AnAerobics project activities in thirty-three Quarterly Reports, twenty-two summary updates pertaining to Ecovation, and seven compliance filings related to Commission Orders.

Further improvements in the RDF process

Despite the criticisms of Xcel's contracting procedures in 2004 (by both the DOC and Commission staff), in the current proceeding, the DOC commended Xcel for implementing improvements in these procedures since then. However, the DOC went on to note that there are opportunities to build on improvements to date, stating:

> Further, the Department believes that there is still room for improvement of the RDF administrative and contractual processes by Xcel. In particular, the Department notes that Xcel's April 6, 2007 proposed RDF grant contract with RCM Digesters, Inc. and Xcel's November 6, 2012 filing requesting approval of an assignment of the RDF grant contract from RCM Digesters, Inc. to Diamond K Feeds, LLP missed at least one red flag–the availability (at the time of the execution of the grant contract and at the time of the proposed assignment) of the needed fuel supply at a reasonable cost - a reasonable project management process would have identified. [See Department's December 6, 2012 comments, in 03-1883, pp. 4-5.]

As noted by the DOC, it is Xcel's responsibility to execute and manage RDF grant contracts in the best interest of ratepayers. Keeping Xcel accountable is key to ensuring that appropriate procedures are put in place, implemented and updated. For this reason, the Commission may wish to encourage Xcel and the DOC to meet to discuss and update their understanding of issues related to contract due diligence and grant management such as: attention to reliable feedstock supplies, counterpart credit, reliance on third party hosts and suppliers, acceptable mitigation measures for risk management, and triggers for project default. At issue in this and future cases may be to define Xcel's responsibility in secondary and other contract contingencies, especially as administrative and contract experience evolves.

Staff conclusion

In negotiating RDF contracts, Xcel must balance the best interests of ratepayers with the needs of the RDF grantees at the same time that it works to further the RDF mission to remove barriers to market implementation of renewable energy.[8] Staff believes that in the 11 years since the

[8] Minn. Stat. 116C.779, Subd. 1 (d), describes the purposes of RDF funding as:

AnAerobics project termination and the deferral of a decision whether to disallow the $1.1 million payment, many of the facts surrounding the case have changed. While there were reasons in 2004 to question the prudence of Xcel's management of the AnAerobics RDF contract, since then Xcel has implemented administrative and contractual improvements including lump sum payments, standardized contracts, and project reporting requirements. The Commission adopted these improvements in its Order of August 3, 2005 and October 5, 2006 (in Docket No. 00-1583). Specifically, the fact scenario under which the Commission will now make a determination, includes the following: (1) a decision from the Commission based on the complete record in 2004 to defer disallowance to a later time, (2) almost 11 years passage of time, and (3) significant changes and improvements in the RDF process as a result on of these experiences.

If the Commission decides not to disallow the recovery of the $1.1 million, and to endorse the sale and/or repurposing of the generation equipment, staff does not believe such a decision will limit the Commission's ability in the future to deny RDF projects costs under an alternative set of facts.

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(1) to increase the market penetration within the state of renewable electric energy resources at reasonable costs;

(2) to promote the start-up, expansion, and attraction of renewable electric energy projects and companies within the state;

(3) to stimulate research and development within the state into renewable electric energy technologies; and

(4) to develop near-commercial and demonstration scale renewable electric projects or near-commercial and demonstration scale electric infrastructure delivery projects if those delivery projects enhance the delivery of renewable electric energy.

Decision options

1. Find that the costs of the Cycle 1 AnAerobics project were prudently incurred. Approve the Company's prior cost recovery of the $1.1 million paid to AnAerobics.

2. Find that Xcel has not demonstrated that the costs of the Cycle 1 AnAerobics project were prudently incurred. Require the Company to return the $1.1 million paid to AnAerobics by crediting the RDF tracker account for this amount for use in future RDF funding cycles. Find that any proceeds from the sale of the AnAerobics generation equipment may be retained by Xcel. Require Xcel, within 15 days of the date of the Commission's Order in this matter, to file a refund compliance plan.

3. Approve Xcel's proposal to sell the generation equipment from the Cycle 1 AnAerobics project and to credit the proceeds from the sale, a minimum of $50,000, to the RDF tracker account for use in future RDF funding cycles.

4. Require Xcel to meet with the DOC to discuss the issues raised above and/or other issues relevant to further improvements to Xcel's RDF administration including contract due diligence and grant management and to file a written summary of the outcome of these discussions by February 17, 2014.