

ATTACHMENT 7

CONTRACT STRATEGY SUMMARY

Docket No.
PU-11-163/ PU-11-165

OTP/MDU-108

Sargent & Lundy LLC

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December 14, 2010
Project No. 12715-001
Letter No. BSP-SL-OTP-0016

Otter Tail Power Company
Big Stone Plant

Contract Strategy Summary

Mr. Mark Rolfes
Otter Tail Power Company
215 S. Cascade Street
Fergus Falls, MN 56538-0496

Dear Mr. Rolfes:

Projects as large as the Big Stone AQCS project demand careful consideration of the contract strategy used to execute the project. The strategy that fits this project best is determined by balancing the risk associated with cost, schedule, and performance against the opportunities offered by the current market conditions. While schedule is not a determining factor for this project, cost and reliability need to be considered carefully. The contract strategy chosen for any project has a direct impact on cost: date certain, price certain, single turnkey contract approach is the most expensive and could cost 10% or more (\$50,000,000+) than a more selective approach that is configured to leverage the current slow marketplace to the advantage of the Owners.

While most risks can not be eliminated, they can be balanced by the execution strategy to provide the Owner the best project for the least cost within a defined timeframe. Cost control includes both the ultimate life cycle cost of the project as well as cash flow, and the potential for cost over runs, or cost certainty. For the purpose of comparing the various strategies, it is assumed that all strategies will have the appropriate terms and conditions to keep the quality of the installed product and safety during construction the same across all methods.

Exhibit 1 depicts the cyclic nature of the marketplace associated with environmental projects. The graph depicts two cycles occurring since 1999, each approximately 6 years in length and predicts another cycle to occur in the next six years going forward. The historical data is based on Sargent and Lundy's knowledge of the industry along with input from project participants where possible. The forward projections are based on Owner input where available combined with our opinion of which projects would begin over time.

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Mr. Rolfes
Ottertail Power Company

The cyclic nature of the environmental marketplace is a direct result of being driven by a central outside influence: regulatory requirements. Historical costs have varied over time in response to the market place. Considering FGD projects as an example, the midpoint of the range of historical costs tracked in 2007 was \$300/kw and four years later in 2011, the midpoint is approximately \$500/kw. That represents a 67% increase in cost over a four year period. The rate of increase for SCR projects is similar but slightly less. Exhibit 1 indicates that we are currently at the end of one cycle and poised to begin another which means that we are in a buyer's market and that the advantages of that is likely to diminish rapidly based on historical data.

The best way to keep the prices as low as possible is to allow companies to do what they do best in terms of engineering, fabrication and erection and establish their respective scopes of work to minimize or simplify interfaces. It is imperative that the price of construction, which is nearly 50% of the cost of the project, be determined based on a developed design with the appropriate risk/reward driving performance. This is especially critical for environmental projects because they tend to be unique given the unique constraints of the existing sites. This uniqueness makes it very difficult to determine the price of construction with certainty by looking at past similar sized projects. Enough engineering must be completed to identify the project unique challenges and allow the constructor to determine the cost with confidence. This eliminates the need for excessive contingencies.

The spectrum of contract strategies possible are bracketed by two extremes: at one end is a date certain/price certain turnkey project and the other is the more traditional multi contract style where there are numerous suppliers and contractors all managed by the Owner or Owner's Engineer. We do not recommend either approach for this project at this time. The single turnkey style is too costly, would reduce the Owner's ability to use schedule to your advantage early in the project, restricts the Owner's ability to select individual OEMs and contractor combinations, eliminates more cost effective regional contractors who can not stand up to wrap guarantees, restricts the Owner's input during design development, and increases cost by the turnkey supplier's need to add contingency to their bid due to the fact their bid is based on minimal engineering: probably something on the order of 5% of the engineering needed to complete the design. There are differing opinions of what that cost impact is, but there is no argument that the premium is real. We do not believe the current marketplace warrants that kind of expense.

The traditional multi contract approach should not be considered at this time either. While this will deliver the least cost project, the incremental cost savings compared to a simpler version called an island approach, which is a hybrid between turnkey and multi contract, is too small to outweigh the risks associated with the more complicated nature of a traditional multi-contract approach. The multi contract approach is better suited to a more active, or "seller's" marketplace where there is more to be gained by breaking the project down into it's fundamental building blocks.

We believe that the optimal approach to the project is as follows:

- Boiler modifications to be designed and installed by one company
- FGD Island is an engineer and furnish only contract from scrubber inlet to baghouse outlet. This does not include foundation, electrical supply or controls which will all be in the Balance of Plant (BOP) scope.
- SCR catalyst supply includes flue gas modeling,

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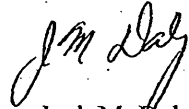
- The Balance of Plant is designed by one BOP Engineer who is responsible to manage and integrate the BOP suppliers with the FGD and SCR island suppliers
- The entire project (excluding the boiler modifications) will be installed by one Contractor

This configuration provides all the benefits of a turnkey approach, with the exception of when the final price will be known, plus the following:

- Owner can choose the technology suppliers separate from the contractor
- Owner can participate in the design development without excessive cost impact
- Owner has much more schedule flexibility to react to market changes or regulatory issues.
- Cost is kept to a minimum by giving the Contractor a developed design to bid from. There will be no need for the Contractor to include higher contingencies to account for unknowns and the contract can be configured to incentivize performance and share risk rather than shed risk.
- More competitive bidding by structuring the contract so experienced/competent regional contractors can bid. Due to the size of this project, only large national contractors have the risk tolerance to bid a single turnkey project.

We believe that the nature of this project and the current market conditions clearly support the hybrid contract approach described above. With the appropriate schedule management and timely decision making, this approach will out perform all other variations in terms of risk management and overall project cost. This simple hybrid variation will allow the Owner to take full advantage of what the industry currently has to offer.

Yours very truly,



Jack M. Daly
Project Director

JMD:cl
Enclosure -- All Recipients
Copies:
K. A. Mixer
File Nos. 2.03 \ 1.16
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Exhibit 1

FGD and SCR Market Activity

Market Activity (Past and Future)

