FILE COPY

AQUILA, INC.
CASE NO. EF-2003-0465
DATA REQUEST NO. OPC-5008

DATE OF REQUEST: July 3, 2003

DATE RECEIVED: July 3, 2003

DATE DUE: July 23, 2003 **Supplemented 9/3/03.**

REQUESTOR: Douglas E. Micheel

QUESTION:

Please provide complete copies of any and all testimony, recommendations, or comments filed in the Minnesota docket G007, 011/S-03-681.

RESPONSE: Please see attached.

ATTACHMENT: Copy of Aquila, Inc.'s Reply Comments filed on August 29, 2003.

ANSWERED BY: Mark Reed

SEP 0 3 2003

STATE OF MINNESOTA
BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

LeRoy Koppendrayer	Chair
Marshall Johnson	Commissioner
Phyllis Reha	Commissioner
Gregory Scott	Commissioner

In the Matter of a Request by Aquila, Inc. for Authority to Use Aquila Networks-PNG and Aquila Networks-NMU Utility Property To Secure Indebtedness

MPUC Docket No.: G007,011/S-03-681

AQUILA, INC. REPLY COMMENTS

These Reply Comments are submitted by Aquila, Inc. and its Divisions Aquila Networks-PNG and Aquila Networks-NMU ("Aquila"), in response to the Minnesota Department of Commerce ("Department") and Office of Attorney General ("OAG") August 19, 2003 Comments concerning Aquila's request to encumber its Minnesota utility property to secure the payment of $250 million of a $430 million loan and to secure future replacement debt offerings for working capital requirements. The Department recommends that the Minnesota Public Utilities Commission ("Commission") deny Aquila's request because Aquila cannot, without incurring significant and otherwise avoidable penalties, buy down the Term Loan as fast as the Department would prefer. The Department's recommendation is premised on the mistaken belief that it would be in the best interest of the ratepayers and the Company to use the proceeds from the sale of non-utility assets to eliminate as much of the Term Loan as quickly as possible. The OAG's recommendation is premised on the mistaken belief that Minn. Stat. § 216B.49 requires utility operations to be funded by stand-alone debt. There is nothing in Section 216B.49 supporting such a conclusion, and the argument ignores the reality of how a utility that is not owned by a holding company must operate.

Further, approving Aquila's application does not increase the risk of bankruptcy and, therefore, does not increase the risk to ratepayers. But denying Aquila the capital it needs as part of its overall financial plan to regain the status of an investment grade utility is harmful to the public interest. Therefore, the Commission should approve Aquila's request as a good faith effort to resolve its financial problems with no additional risk, or cost to the ratepayers.

As will be described in more detail in subsequent sections of this response, the recommendations of the Department and OAG are detrimental to the financial position of Aquila for the following reasons:

1. Aquila would be required to retire lower-cost debt and not maximize the benefit of its asset sale proceeds.
2. Aquila would have less cash available to repay the 2004 debentures when they become due if it is required to use the asset sale proceeds to retire the term loan, potentially leading to a liquidity crisis.
3. Aquila's financial plan enables the customers to receive a lower cost long-term debt rate by guaranteeing them an investment-grade utility rate. Changing this plan to meet the Department's mandatory prepayment requirement, on the other hand, jeopardizes Aquila's financial well-being without providing any benefit to customers.

A. Artificially Accelerating Repayment Of The Term Loan Would Not Be In The Public Interest.

Aquila is in the process of selling all of its remaining unregulated assets. Because of the need to time these sales to maximize their value, at least some of the assets are expected to remain on Aquila's books for one to two years. The Department recommends rejecting Aquila's Application because the Company would not be able to buy down the Term Loan as quickly as the Department prefers. The Department's preference, however, is based on the faulty premise that retaining more than the minimum amount of the Term Loan would not be in the ratepayer's or Company's best interest. In fact, the Company needs the flexibility to retain the maximum amount of the $180 million Term Loan supportable by nonregulated asset collateral.

During discussions with the Department, the Department requested that Aquila accelerate, to the maximum extent possible, the buy down of the nonregulated portion of the debt (the $180 million supported by nonregulated assets). Aquila's representatives agreed to take that request back to the people responsible for managing Aquila's financial plan to determine whether such a request was both feasible and in the overall best interest of Aquila's financial needs. As explained in Aquila's August 1, 2003 letter to the Department, which is appended to the OAG's comments, the forced early retirement of the Term Loan would be harmful to Aquila's financial position.

Aquila's present primary financial goal is to become an investment grade utility. Becoming an investment grade utility is in the public interest because utilities need access to large amounts of capital to assure safe, reliable and affordable service. While Aquila can meet those needs in the short run without being an investment-grade utility, it would, over time, become increasingly more difficult and expensive.

The Department incorrectly assumes that the Company can further that goal with the early retirement of the Term Loan. It cannot. The Department assumes that even at 8.0% (the reduced rate available to Aquila if the Term Loan is secured by adequate utility assets) the loan is a high cost loan for Aquila. *It is not.*

Aquila has $500 million of 14.875% debt; $250 million of 9.95% debt; $20.2 million of 9.03% debt; $5.0 million of 9.0% debt, and another $120 million of debt at 8.2%. Using the proceeds from the sale of the nonregulated assets to buy down debt improves the Company's financial position over the forced retirement of the Term Loan. Aquila needs the flexibility to make the most cost effective decision in order to achieve financial stability.

Even more pressing is the fact that the Term Loan requires Aquila to redeem at least 80% of the July 2004, $150 million and October 2004, $250 million bonds prior to their respective maturities, or the entire Term Loan of $430 million becomes due. If Aquila uses the proceeds from the nonregulated and international asset sales to prematurely retire the $180 million portion of the Term Loan, and therefore does not have sufficient cash to retire the 2004 debt maturities, Aquila will be forced into a loan default and potential bankruptcy. Therefore, it is preferable for Aquila to use the proceeds from the sale of its nonregulated assets to repay those bonds rather than repay the Term Loan which does not mature until April, 2006. If the proceeds of the nonregulated assets are diverted to repay the Term Loan rather than the maturing bonds, the risk that Aquila could be forced into default of the Term Loan and bankruptcy increases.

Retiring the 2004 bond series, which are at 7% and 6.875%, would also benefit the ratepayers. That debt has been assigned to domestic utilities, including Aquila Networks-PNG and Aquila Networks-NMU. If Aquila is able to retire that debt, Aquila will need to assign replacement debt to the utility operations to maintain the proper debt/equity ratio. Aquila would most likely assign existing debt on its balance sheet to the utilities for that purpose, and, pursuant to Aquila's commitment, all debt assigned to a utility operation would be assigned at the then current BBB investment rate. Based upon current information available to Aquila, the interest rate for BBB rated long-term debt is 5.95% for 10-year bonds. Consequently, the weighted average cost of debt to the utility operations would be reduced. The difference between the actual cost of the debt on Aquila's balance sheet and the assigned BBB investment rate would be borne by Aquila and not the ratepayers.

In addition, the Department's earlier June 30th Comments acknowledge that if the State Commissions allow enough utility property to be used to secure the Term Loan Facility, a 75 basis point reduction in the interest rate would occur (decreasing interest expense by $3.2 million a year). The Department provides no justification for potentially foregoing that significant cost saving.

The "Recommended Decision of Administrative Law Judge Dale E. Isley approving Stipulation and Settlement Agreement" for the State of Colorado, at paragraph 16, makes the following finding concerning the relationship of the debt issuance and the goal of becoming an investment grade utility:

> The parties believe that granting the application, subject to the terms of the Stipulation, is in the public interest. Having reviewed the Stipulation, the application, the prefiled testimony and exhibits submitted by Aquila in this matter, and the testimony presented by the parties at the hearing, the undersigned agrees. **Subject to the conditions contained in the Stipulation, approval of the pledge of Aquila's Colorado utility assets to secure the loan will greatly assist Aquila's efforts to implement the Financial Plan and, ultimately, should serve to return it to a capital structure reflective of a gas and electric utility and to restore its debt rating to investment grade.**

(Emphasis added.) The Colorado Administrative Law Judges' ("ALJ") recommended decision approving the encumbrance application became final on July 10, 2003, and a copy was attached to Aquila's July 15th Comments in this Docket. Jon Empson's Supplemental Direct Testimony included a copy of the referenced Stipulation. As stated on page 4, line 3, of that Testimony, Aquila accepts the conditions outlined in the Colorado Stipulation for application in Minnesota.

Aquila acknowledges the Department's intent to protect the overall ratepayer interests. However, this is an area where the financial pieces are too complex and fluid to be managed under unnecessary restrictions. Aquila is doing everything it can to overcome its financial problems, and needs the flexibility it has requested to return to being an investment grade utility.

B. It Is Neither Possible Nor Necessary To Compartmentalize The Term Loan As The OAG Prefers.

The OAG asserts that "a legal firewall between the loan provisions concerning regulated and unregulated obligations must be erected." It is erroneously suggested that Minn. Stat. § 216B.49 may require such a result. Further, contrary to the OAG's assertion, Aquila's Application is not inconsistent with its statements to the Commission in Aquila's last rate case.

Aquila is not a holding company, and its operating divisions are legally indistinguishable from Aquila, Inc. As such, the utility operations cannot issue stand-alone debt. Despite that legal necessity, Aquila has assured that the cost of providing utility service is determined as if Aquila had only utility operations. Consequently, in its last rate case, Aquila and the Department agreed that a separate **assigned** divisional capital structure, rather than Aquila's consolidated capital structure, should be used to determine the Aquila Networks-PNG and Aquila Networks-NMU revenue requirements.

Aquila and the Commission reinforced the use of an appropriate **assigned** divisional debt, rather than Aquila's consolidated capital structure, for determining the cost of debt in its next rate case, as memorialized in the Commission's February 14, 2003 ORDER APPROVING JOINT RECOMMENDATION, *In the Matter of an Inquiry into Possible Effects of the Financial Difficulties at Aquila, Inc. on Peoples Natural Gas Company and Northern Minnesota Utilities Company,* Docket No. G-007,011/CI-02-1369, requiring Aquila to:

(a) identify all issuances of debt and associated costs from January 1, 2002, until the next rate case in a manner that will facilitate a potential adjustment to mitigate the impact of adverse market factors caused by

Aquila's financial problems. Specifically, Aquila shall provide information sufficient to allow the Commission to evaluate what the debt and equity costs for Peoples and NMU would have been but for the effect of Aquila's other operations; and

(b) provide a discussion and analysis of the effects of Aquila's financial situation on Peoples' and NMU's cost of common equity.

Clearly, Aquila has never asserted that it would not have consolidated debt or that its utility operations would issue stand-alone debt. Rather, Aquila has consistently acted to ensure that the cost of the debt allocated to its utility operations reflects the cost of debt appropriate to an investment grade utility. Aquila continues to support such a result, and its promise to use the cost of debt for an investment grade utility for any new debt assigned to a utility is fully consistent with Aquila's past practices and promises of future behavior to the Commission.

Nor does Minn. Stat. § 216B.49 require that utility debt be stand-alone debt. The OAG notes that the statute requires a "public utility" to obtain Commission approval before issuing debt. More specifically, Section 216B.49, subd. 3, provides simply:

> It shall be unlawful for **any public utility** organized under the laws of this state **to sell any security** or, if organized under the laws of another state or foreign country, to subject property in this state to an encumbrance for the purpose of securing the payment of any indebtedness **unless the security issuance of the public utility** first be approved by the commission.

(Emphasis added.) Under the OAG's interpretation of this provision, utilities would need to issue stand-alone utility debt. As such, all utility companies would either be required to engage exclusively in regulated operations or they would be required to adopt a holding company organizational structure. Under the OAG interpretation, a Minnesota domiciled non-holding company, like Aquila, Inc., which is the same legal entity as Aquila Networks-PNG and Aquila Networks-NMU, could not issue **any debt** for non-utility purposes. Clearly that is neither contemplated nor required. If it were, it would be expressly stated, and would most likely be preempted by the Public Utility Holding Company Act of 1935 ("PUHCA")[1].

While the OAG seems to contemplate an agreement with the lenders that would compartmentalize Aquila, Inc. into regulated and unregulated enterprises, it is highly doubtful that such distinctions would have any effect in the event of a default and bankruptcy. Further, the protection the OAG seeks is unnecessary. The Department states (page 10) in its earlier June 30th Comments: "In sum, the risk for the ratepayers does not appear to be any greater with encumbrance than without encumbrance in bankruptcy." In fact, issuance of debt needed for operational needs at a reasonable cost decreases, rather than increases, the risk of bankruptcy or default.

Finally, the OAG ignores that the issuance of consolidated debt was necessary to obtain the funds Aquila needed for its utility cash working capital needs. Aquila needed to replace $650 million of revolving credit agreements and other maturing obligations that became due on April 12, 2003 or it would go into default and likely bankruptcy. To do so, Aquila needed to issue new debt, and to obtain that debt, Aquila needed to secure the debt. $250 million of the new debt was needed to meet the cash working capital needs of Aquila's utility operations. Aquila could not provide adequate security for the $250 million needed for its utility operations using only utility property by April 12th because of the need to obtain regulatory approvals. Therefore, Aquila was forced to issue consolidated debt, initially using primarily nonregulated assets to secure the debt needed by its utility operations. Under the OAG's interpretation of Section 216B.49, a Minnesota domiciled utility could not have issued the consolidated debt at all, and a utility organized in another state, like Aquila, could not secure the portion of the

[1] PUHCA, 15 U.S.C. § 79 et. al. closely regulates and limits the use of a holding company structure in conjunction with public utility operations.

consolidated debt needed for utility operational purposes. Such an interpretation of the statute is unreasonable. Aquila's utility operations are benefiting from the Term Loan and should provide the security needed to support the Term Loan.

In summary, the Company is moving with all reasonable speed to sell all of its unregulated assets. When those assets are sold, the Term Loan will be reduced to the $250 million needed for utility operations.

In its July 15, 2003 Reply Comments, Aquila made the following commitment:

> The amount of Term Loan Facility secured for utility operations will not exceed $250 million (unless a subsequent Aquila request is approved by the Commission authorizing an increase in utility working capital (e.g. because gas costs have increased). To the extent that the Term Loan Facility is used for both utility and non-utility operations, the amount of debt used for non-utility operations will be secured by sufficient non-utility assets (at a ratio of at least 1.67 to 1). The amount of the non-utility debt will be reduced as necessary to meet this commitment.

Therefore, the Company has done all that it can under these circumstances to match the use of security to the purpose of the debt. To adopt the OAG interpretation of Section 216B.49, subd. 3, would essentially deny all but stand-alone utilities access to debt. Such an interpretation is contrary to the operating needs of utilities and contrary to the public interest.

C. Conclusion.

The request to encumber Minnesota regulated assets should be approved by the Commission:

- It is in the public interest.
- Ratepayers will not assume responsibility for debts incurred to support nonregulated businesses.

The amount of Term Loan Facility secured for utility operations will not exceed $250 million (unless a subsequent Aquila request is approved by the Commission authorizing an increase in utility working capital, e.g. because gas costs have increased). To the extent the Term Loan Facility is used for both utility and non-utility operations, the amount of debt used for non-utility operations will be secured by sufficient non-utility assets (at a ratio of at least 1.67 to 1). The amount of the non-utility debt will be reduced as necessary to meet this commitment.

Dated: August 29, 2003

Respectfully submitted,

By ______________________________
Michael J. Bradley

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Attorneys on Behalf of Aquila, Inc. and its Divisions Aquila Networks-PNG and Aquila Networks-NMU

AQUILA, INC.
CASE NO. EF-2003-0465
DATA REQUEST NO. OPC-1001

DATE OF REQUEST: May 14, 2003

DATE RECEIVED: May 14, 2003

DATE DUE: June 3, 2003

REQUESTOR: Ted Robertson

QUESTION:

Please provide copies of all data request/interrogatory questions received from the state of Iowa regulatory staff(s), and all other intervenors in Iowa, regarding Aquila's reorganization activities, and the encumbrance of Iowa assets. This is a continuing data request; please update your response on a weekly basis.

RESPONSE: Please find attached the responses to the Iowa Office of Public Counsel's (OCA) data requests No.'s 1 –17.

ATTACHMENT: Responses to OCA data requests No.'s 1-17

ANSWERED BY: Mark Reed

MAY 2 2 2003

Schedule TJR-16.1

AQUILA, INC.
CASE NO. SPU-03-7
DATA REQUEST NO. OCA-13

FILE COPY

DATE OF REQUEST: May 14, 2003

DATE RECEIVED: May 14, 2003

DATE DUE: May 19, 2003

REQUESTOR: John F. Dwyer

REFERENCE: Direct Testimony of Rick Dobson, Page 10, Line(s) 13-15

QUESTION:

Provide all research, analysis, work papers or any other support used to determine what portion of the $250 million deemed to be needed to support the on-going working capital requirements of the domestic utility business is required for Iowa gas operations.

RESPONSE: We have estimated through an internal study and by reviewing the working capital facilities of similar utilities (see Exhibits RD-3 and RD-4 to Rick Dobson's testimony), that $250 million of the total facility will likely be needed to support utility operations going forward. We did not attempt to "allocate" portions of it to each state operation.

ATTACHMENT: NA

ANSWERED BY: Mark Reed

MAY 22 2003

SCHEDULE TJR-17

HAS BEEN DEEMED

"HIGHLY CONFIDENTIAL"

IN ITS

ENTIRETY

SCHEDULE TJR-18

HAS BEEN DEEMED

"HIGHLY CONFIDENTIAL"

IN ITS

ENTIRETY

AQUILA, INC.

SUPPLEMENTAL TESTIMONY

of

BETH A. ARMSTRONG

In re Aquila, Inc.
Docket No. SPU-03-7

July 18, 2003

Q. Please state your name.

A. My name is Beth A. Armstrong.

Q. Are you the same Beth A. Armstrong who filed rebuttal testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of this supplemental testimony?

A. In this supplemental testimony, I will respond on behalf of Aquila to the following questions posed by the Board in the order issued in this proceeding on July 3, 2003: question nos. 7, 8, 9, 10, 11, and 12. Most of those questions relate to my Exhibit (BAA-1) I filed with my rebuttal testimony. In order to facilitate the Board's understanding of my exhibit, I will devote a portion of my supplemental testimony to a detailed explanation of my calculation of Iowa's share of the working capital requirement. I am also submitting with this testimony a revised Exhibit (BAA-1) in order to clarify the abbreviations and calculations used in the exhibit and to adjust a percentage used for allocation purposes.

Q. Would you please describe in detail the calculation of Iowa's portion of the working capital requirement?

A. Yes. The working capital requirements were initially developed for U. S. Networks in total. This analysis was performed at a total U.S. Networks level for cash management purposes because it is important to know when the coincident peak working cash requirement occurs across the entire utility system versus determining utility by utility peaks that may occur at different times during the year but be offset by the working capital generated from another utility. This is the analysis that supports the $250 million peak requirement discussed in Rick Dobson's direct testimony. In response to data requests and direct testimony submitted by Mr. Vitale from the Office of Consumer Advocate (OCA), we further analyzed the state by fuel breakdown of the $250 million in order to estimate Iowa's portion of the total working capital requirement during the U.S. Networks coincident peak.

Q. What factors does the working capital requirement study consider in determining the U.S. Networks peak working capital need?

A. The working capital study is designed to calculate the net cash outstanding by day. In order to arrive at this daily requirement we considered both cash disbursements and cash receipts. Based on this study we determined that the peak cash requirement occurs in the first few days of January. This peak is driven by gas supply purchases lagging the collection of cash during this peak supply period. Gas Supply payments outstanding during the first few days of January include: (1) payment for gas used in December (the study assumes that December gas is predominantly collected in January based upon the billing cycles); (2) the prepayment of January gas; (3) payments for gas injected into storage less an amount for gas removed from storage through early January; and (4) prepaid pipeline capacity charges The total cash outstanding was then netted with the estimated cash receipts for the month of January The January 2004 estimated cash receipts have been increased over 2003 actual receipts to include the effect of increased gas costs.

Q. Are you submitting with this supplemental testimony a revised Exhibit BAA-1 and supplemental schedules thereto?

A. Yes.

Q. What is the purpose of your revised exhibit?

A. To provide clarity to abbreviations and calculations used in the original schedule(s) in addition to adjusting a percentage used for allocation purposes.

Q. Please explain the information included on the revised exhibit.

A. In order to estimate the Iowa portion of the working capital requirement, we first estimated Iowa's portion of each of the various components of cash payments outstanding and then Iowa's percentage of cash receipts.

Q. Explain how Iowa's portion of the cash outstanding was determined.

A. Iowa's portion of the cash payments was determined based upon the sum of:

(1) December's gas payment which was allocated on Iowa's percentage of December gas volumes.

(2) January's gas payment which was based on Iowa's percentage of January's gas volumes.

(3) The gas storage amount was originally based on January's percentage (16.0%) however I have corrected the percentage in this testimony to be the average for the period January through March (15.8%) representing the remaining winter months for storage withdrawals.

(4) The prepaid pipeline capacity charges were originally based on January's percentage (16.0%); however, I have corrected the percentage in this testimony to be the average for the period January through March (15.8%), as the capacity charges are prepaid three months in advance.

Q. How did you determine the amount of the U.S. Networks cash receipts to be applied against the Iowa payments outstanding?

A. Since Iowa's cash receipts are not specifically identified in our accounting system, we developed a percentage to allocate a portion of the Peoples Natural Gas (PNG) cash receipts to the state of Iowa.

Q. How did you arrive at this percentage of Iowa's receipts to the total PNG cash receipts?

A. We used Iowa's average percentage (22.5%) of PNG's historical revenues for the months of December 2002 and January 2003. This historical revenue percentage (22.5%) was then applied to actual cash receipts for PNG's cash receipts for January 2003 yielding a result of $20,325,385. The $20,325,385 was then divided by the U. S. Networks total receipts of $165,200,871 for January 2003 to determine a historical percentage of Iowa's cash receipts to total U.S. Networks.

Q. How was the 12.3% historical Iowa cash receipts to the U.S. Networks cash receipts percentage used?

A. The 12.3% was applied to the U. S. Networks projected cash receipts of $213,782,000 for January 2004. This yielded a projected cash receipts amount for Iowa of $26,302,534. This Iowa portion of cash receipts was netted with the cash outstanding calculated above of $60,715,829 resulting in a working capital requirement of $34,413,296.

Q. Can you explain why there is December data included for Gas Supply and not for Storage and Pipeline Capacity? (IUB No. 7 a.)

A. Yes. The gas storage amount is the projected balance as of the first of January for gas injected into storage during April through October of the 2003 less amounts projected to be withdrawn during the 2003 November and December heating season based upon the winter 2003-2004 gas supply plan. Pipeline capacity charges represent capacity prepayments for January through March because Aquila is currently required to pay at the first of the month for the next three months of capacity on Northern Natural Pipeline.

Q. Are the amounts used for gas purchases in the exhibit sensitivity tested for colder than normal weather or significantly increased gas prices? (IUB No. 7 b.)

A. Yes, as explained in my rebuttal testimony, page 7, lines 19-27, we stress tested the working capital requirement for higher gas prices and increased volumes to simulate the effects of a colder than normal weather scenario. We believe it is prudent from a cash management perspective that the Company has enough working capital capacity to meet these stress test conditions.

Q. Does the Cash Receipts amount on the Exhibit BAA-1 include more than one month of receipts? (IUB No. 7 c.)

A. No, the cash receipts shown in Exhibit BAA-1 are projected receipts for the month of January 2004. Payments have been accelerated due to our current credit conditions but this has had no impact on the timing of cash receipts from customers.

Q. If the Cash Receipts are for only one month, why are two months of gas supply applied to it? (IUB No. 7 d.)

A. December 2003 and January 2004 supply cost is outstanding because Aquila must prepay its gas purchases before the gas flows to our customers. Aquila will not bill for this supply until after the gas is metered to the customer. Cash collections will also lag the bill date under the customer payment terms. Therefore Aquila will not collect the full amount for December gas purchases from the customer until January and January gas supply will not be collected until February.

Q. On Exhibit BAA-1, Supplemental Schedule 2, Iowa's portion of cash receipts is calculated at 12.3 percent. Explain how the 12.3 percent is calculated. (IUB No. 8 a)

A. The 12.3% is calculated by dividing Iowa's January 2003 estimated cash receipts of $20,328,385 by total U. S. Networks January 2003 cash receipts of $165,200,871.

Q. Do the receipts/ revenues listed on Supplemental Schedule 2 include electric receipts/revenues? (IUB 8 b.)

A. The revenues listed on Supplemental Schedule 2 represent actual December 2002 and January 2003 revenues for PNG and therefore only reflect gas revenues. They were used as a basis to allocate a portion of the PNG January 2003 cash receipts to Iowa. The January 2003 actual cash receipts represent U. S. Networks in total and therefore include electric receipts from the electric operating divisions. This January 2003 U.S. Networks cash receipt total is used to determine Iowa's historical percent of total utility cash receipts. The 12.3% was then applied to the 2004 projected cash receipts for the U.S. Networks from the study.

Q. Under Cash Receipts for Jan 03 on Supplemental Schedule 2, abbreviations such as MGD are used. Provide a full description for each of the abbreviations. (IUB No. 8 c.)

A. See the revised exhibit attached to this testimony for detailed unit descriptions.

Q. Why is the total for PND Revenues by State Jan Rev on Supplemental Schedule 2 different from the PND amount under Cash Receipts for Jan 03 on Supplemental Schedule 2? (IUB No. 8 d.)

A. January 2003 Cash Receipts on Supplemental Schedule 2 is the amount of cash collected during the month of January 2003 and would include a portion of December cycle bills due in January as well as a portion of January cycle bills also due in January. This is why a two-point average of December and January revenues was used as an allocation basis for January cash receipts for Iowa.

Q. Are all of the numbers on Exhibit BAA-1, page1, Supplemental Schedule 1, pages 1-2, and Supplemental Schedule 2 projected numbers? Do any actual numbers exist for this information? Also, could you provide the year to which the numbers are applicable? (IUB No. 9)

A. See the clarification of labels on the revised exhibit attached to this testimony. The general methodology outlined in this exhibit is to use actual data from the prior year where applicable to determine the allocation factors that are then applied to the projected January 2004 information. The numbers on Exhibit BAA-1, page 1, Supplemental Schedule 1, pages 1-2, are budgeted MCF by state for 2003 and 2004. This projected information was used to estimate Iowa's portion of December 2003 and January 2004 gas purchases. On Supplemental Schedule 2, the information depicts actual results. The cash receipts listed are actual results for PNG for January 2003 and the revenues listed are actual results for December 2002 and January 2003. The actual revenues were used as a basis for determining an allocation factor for Iowa's portion of the PNG cash receipts. A second allocation factor was computed using estimated Iowa January 2003 cash receipts as a percent of the January 2003 total utility cash receipts. This factor (12.3%) was applied to projected January 2004 total U.S. Networks receipts.

Q. Explain why the amount shown for Cash Receipts for Jan 03 Exhibit BAA-1, Supplemental Schedule 2, is a different amount than Cash Receipts on Exhibit BAA-1, page 1. (IUB No. 10)

A. The Cash Receipts for Jan 03 Exhibit BAA-1, Supplemental Schedule 2, represent the actual cash collected during January 2003. The Cash Receipts on Exhibit BAA-1, page 1, are the projected cash receipts for January 2004 and include the effect of the increased gas costs.

Q. In the last paragraph of the last page of Confidential Exhibit __(RD-3), Aquila discusses information for U.S. Networks. Provide corresponding information for Iowa only for the same period. (IUB No. 11)

A. The Iowa under-recovered PGA balance as of February 2001 was $18,400,833 and the budget bill under-billed balance for February 2001 was $18,256,596. Therefore Iowa contributed to a liquidity gap of $36,65,429 (sum of the above) in 2001.

Q. Do you wish to make any comment about IUB No.12?

A. Yes. While the question appears to be directed to the Consumer Advocate, I would like to re-emphasize that Aquila is asking not for rate-making treatment on the calculation of the working capital requirement, but only for the ability to collateralize its Iowa assets in order to secure the necessary funding to support the working capital requirements.

Q. Does this conclude your supplemental testimony?

A. Yes.

AFFIDAVIT

STATE OF MISSOURI)
) SS:
COUNTY OF JACKSON)

I depose and state, being first duly sworn on oath, that I am the same Beth A. Armstrong identified in the foregoing supplemental testimony; that I have caused such testimony to be prepared and am familiar with the contents thereof; and that such testimony is true and correct to the best of my knowledge and belief as of the date of this affidavit.

Dated July 17, 2003.

Beth Armstrong
Beth A. Armstrong

Subscribed and sworn to before me this 17th day of July, 2003.

Lana S. Jennings
Notary Public in and for
the State of MISSOURI

LANA S JENNINGS
Notary Public - Notary Seal
STATE OF MISSOURI
JACKSON COUNTY
MY COMMISSION EXP. JAN. 8,2005

FILED WITH
Executive Secretary

JUL 18 2003

IOWA UTILITIES BOARD

AQUILA, INC.

SUPPLEMENTAL EXHIBIT

of

BETH A. ARMSTRONG

In re Aquila, Inc.
Docket No. SPU-03-7

July 18, 2003

Schedule TJR-19.12

Armstrong Iowa Rebuttal Testimony

Revised Exhibit BAA-1

		Iowa's Estimated Working Capital	Projected Dec 2003	Projected Jan 2004	
	Gas Supply				
	Working Capital Model		$ 131,195,528	$ 145,795,744	
	Iowa Percentage of load		16.1%	16.0%	See Supplemetal Schedule 1
A	**Iowa Portion**	$ 44,562,014	$ 21,164,610	$ 23,397,404	
	Storage			Jan	
	Working Capital Model			$ 70,584,491	
	Iowa Percentage of load			15.8%	See Supplemetal Schedule 1
B	**Iowa Portion**	11,136,538		$ 11,136,538	
	Pipeline Capacity				
	Working Capital Model			$ 31,800,000	
	Iowa Percentage of load			15.8%	See Supplemetal Schedule 1
C	**Iowa Portion**	5,017,277		$ 5,017,277	
D	**Total Cash Needs for Iowa (D= A+B+C)**	$ 60,715,829			
	Cash Receipts				
	Working Capital Model	$ 213,782,000	January 2004 Projected Cash Receipts		
	Iowa % of cash receipts (Avg Dec/Jan)	12.3%	See Supplemental Schedule 2		
E	**Iowa Portion of Cash Receipts**	$ 26,302,534			
F	**Iowa Peak Cash Requirement (F=D-E)**	$ 34,413,296			
	Iowa's % Net Peak Cash Requirement ($34,413,296/$250,000,000)	13.8%			
	Iowa's % of net plant	3%	See Supplemental Schedule 3		

Schedule TJR-19.13

Armstrong Iowa Rebuttal Testimony

Revised Exhibit BAA-1

Supplemental Schedule 1

Calculation of Iowa's portion of natural gas load

Budgeted
MCF Per Load Forecast File

	3-Jan	3-Feb	3-Mar	3-Apr	3-May	3-Jun	3-Jul	3-Aug	3-Sep	3-Oct	3-Nov	3-Dec
MO - MPS	1,083,521	818,141	628,964	345,658	171,160	129,659	126,092	131,520	107,877	289,611	627,403	962,034
MO - SJ	177,152	125,933	99,301	60,759	36,913	15,423	14,917	15,692	28,185	53,148	99,251	144,377
Michigan	4,510,058	3,714,810	3,136,325	1,917,106	941,361	592,412	464,403	505,083	612,149	1,616,039	2,643,862	3,834,411
Minnesota	5,863,095	4,568,721	3,831,111	2,274,271	1,192,105	853,485	732,566	821,853	923,826	2,127,166	3,657,116	5,264,871
Kansas	2,246,710	1,541,087	1,337,998	866,924	533,146	662,707	665,517	679,409	435,752	771,003	1,359,418	1,850,698
Colorado	1,034,704	884,463	837,723	633,771	435,392	370,568	329,334	337,141	309,424	573,410	865,957	1,096,345
Iowa	3,550,583	2,729,983	2,233,957	1,313,146	642,903	490,750	431,804	455,636	471,729	1,158,033	2,066,353	3,041,776
Nebraska	3,728,912	2,963,092	2,385,777	1,410,001	736,887	546,519	523,545	536,860	576,489	1,240,249	2,322,817	2,660,898
Total Networks Load	**22,194,734**	**17,346,231**	**14,491,155**	**8,821,636**	**4,689,865**	**3,661,523**	**3,288,178**	**3,483,194**	**3,465,430**	**7,828,659**	**13,642,177**	**18,855,409**

MO - MPS	4.9%	4.7%	4.3%	3.9%	3.6%	3.5%	3.8%	3.8%	3.1%	3.7%	4.6%	5.1%
MO - SJ	0.8%	0.7%	0.7%	0.7%	0.8%	0.4%	0.5%	0.5%	0.8%	0.7%	0.7%	0.8%
Michigan	20.3%	21.4%	21.6%	21.7%	20.1%	16.2%	14.1%	14.5%	17.7%	20.6%	19.4%	20.3%
Minnesota	26.4%	26.3%	26.4%	25.8%	25.4%	23.3%	22.3%	23.6%	26.7%	27.2%	26.8%	27.9%
Kansas	10.1%	8.9%	9.2%	9.8%	11.4%	18.1%	20.2%	19.5%	12.6%	9.8%	10.0%	9.8%
Colorado	4.7%	5.1%	5.8%	7.2%	9.3%	10.1%	10.0%	9.7%	8.9%	7.3%	6.3%	5.8%
Iowa	16.0%	15.7%	15.4%	14.9%	13.7%	13.4%	13.1%	13.1%	13.6%	14.8%	15.1%	[redacted]
Nebraska	16.8%	17.1%	16.5%	16.0%	15.7%	14.9%	15.9%	15.4%	16.6%	15.8%	17.0%	14.1%
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Iowa average for storage and pipeline capacity payments

Schedule TJR-19.14

Armstrong Iowa Rebuttal Testimony

Revised Exhibit BAA-1

Supplemental Schedule 1

Calculation of Iowa's portion of natural gas load

Budgeted
MCF Per Load Forecast Fil

	4-Jan	4-Feb	4-Mar	4-Apr	4-May	Total Annual		Winter 30-04	
MO - MPS	1,093,214	829,825	634,743	348,958	172,959	5,453,895		4,147,219	
MO - SJ	179,035	127,849	100,439	61,488	37,393	877,199		650,951	
Michigan	4,575,689	3,782,700	3,181,318	1,944,368	954,499	24,706,932		18,017,980	
Minnesota	5,893,616	4,606,215	3,837,703	2,263,375	1,169,124	32,150,916		23,259,521	
Kansas	2,269,615	1,575,171	1,350,625	873,653	537,347	13,030,916		8,405,527	
Colorado	1,094,548	945,273	883,884	666,599	454,744	7,927,226		4,886,006	
Iowa	3,602,938	2,783,910	2,266,847	1,332,359	652,193	18,754,327	15%	13,761,823	16%
Nebraska	3,742,258	2,969,939	2,382,667	1,402,362	717,633	19,622,236		14,078,579	
Total Networks Load	**22,450,914**	**17,620,882**	**14,638,225**	**8,893,163**	**4,695,892**	122,523,646		87,207,607	

MO - MPS	4.9%	4.7%	4.3%	3.9%	3.7%
MO - SJ	0.8%	0.7%	0.7%	0.7%	0.8%
Michigan	20.4%	21.5%	21.7%	21.9%	20.3%
Minnesota	26.3%	26.1%	26.2%	25.5%	24.9%
Kansas	10.1%	8.9%	9.2%	9.8%	11.4%
Colorado	4.9%	5.4%	6.0%	7.5%	9.7%
Iowa	[redacted]	15.8%	15.5%	15.0%	13.9%
Nebraska	16.7%	16.9%	16.3%	15.8%	15.3%
	100.0%	**100.0%**	**100.0%**	**100.0%**	**100.0%**

				Average
Iowa average for storage and pl	**16.0%**	**15.8%**	**15.5%**	**15.8%**

Schedule TJR-19.15

Armstrong Iowa Rebuttal Testimony

Revised Exhibit BAA-1

Supplemental Schedule 2

Calculation of Iowa's portion of cash receipts

U.S. Network Actual Cash receipts	A January 2003 Actual	B Iowa's % of Peoples Natural Gas Cash Receipts	C= A*B Iowa estimated receipts	Iowa's % of U.S. Network Total	
MGD (Michigan Gas Utility Distirbution)	19,151,914.57				
MPD (Misouri Public Service Distribution)	30,268,633.01				
PND (PNG Distribution)	90,446,873.61	22.5%	20,325,385	$\boxed{12.3\%}$	12.3% is 20,325,385 / 165,200,871.25
SJD (St. Joe Power and Light Distribution)	7,608,725.26				
WCD (West Plains Colorado Distribution)	8,993,443.91				
WKD (West Plains Kansas Distibution)	8,731,280.89				
Total receipts for Jan 03	165,200,871.25				

Peoples Natural Gas Revenues by State	Dec 2002 Actual Revenue	Jan 2003 Actual Revenue	Dec rev %	Jan Rev %	Avg (Dec and Jan)	
COLORADO	4,633,466.13	5,510,038.01	6%	5%		
IOWA	19,341,944.41	24,602,573.88	23%	22%		
KANSAS	13,466,583.27	15,995,020.38	16%	14%		
MICHIGAN	18,549.48	14,563.68	0%	0%		
MINNESOTA	27,935,788.35	40,063,557.98	33%	36%		
NEBRASKA	18,615,585.78	25,545,115.56	22%	23%	22.5%	22.5% is the average of 23% and 22%
OKLAHOMA	23,822.88	39,427.87	0%	0%		
PND_GENERAL	153,306.32	(3,277.03)	0%	0%		
SOUTH DAKOTA	82,527.18	70,176.87	0%	0%		
TEXAS	(75,527.58)	33,251.31	0%	0%		
	84,196,046.22	111,870,448.51	100%	100%		

Armstrong Iowa Rebuttal Testimony

Revised Exhibit BAA-1

Supplemental Schedule 3

Percentage of net plant calculation

Balances as of 12-31-02		Gross Plant	Accum Depr	Net Plant		
Gas						
	COLORADO	60,061	26,371	33,690		
	IOWA	139,761	90,423	49,338	3%	3% is 49,338 / 1,707,409.00
	KANSAS	143,734	74,413	69,321		
	MICHIGAN	241,705	115,412	126,293		
	MINNESOTA	210,770	87,690	123,080		
	MISSOURI	93,142	32,859	60,283		
	NEBRASKA	213,378	82,600	130,778		
	OKLAHOMA	370	310	60		
	PND_GENERAL	4,205	1,156	3,049		
	SOUTH DAKOTA	8	11	(3)		
	TEXAS	165	151	14		
Electric						
	COLORADO	226,241	114,522	111,719		
	KANSAS	360,009	180,718	179,291		
	MISSOURI	1,499,008	678,512	820,496		
TOTAL		3,192,557	1,485,148	1,707,409		

Schedule TJR-19.17

AQUILA, INC.
CASE NO. EF-2003-0465
DATA REQUEST NO. MPSC-15

DATE OF REQUEST: May 29, 2003

DATE RECEIVED: May 29, 2003

DATE DUE: June 18, 2003

REQUESTOR: Joan Wandel

QUESTION:

1. Recent cash working capital studies indicate that all the Missouri regulated utilities actually operate at a negative working capital level. In other words, the studies indicate that Missouri ratepayers currently provide cash to the Company in advance of when the Company must pay for products and services related to the provision of utility service to the ratepayers. Why, therefore, in the Company's opinion, should any of the Missouri-regulated utility assets be pledged as part of this collateralization loan agreement as requested in the Company's Application? Please explain.

2. Why, given the circumstances described above and given the regulatory propensity to maintain separate and distinct operations of utilities on a utility by utility basis (natural gas/electric/steam) and on a jurisdictional basis, did the Company not structure its Applications in such a way as to specifically identify those utilities in need of a cash working capital loan facility thereby leaving assets of those utilities not requiring cash working capital loan facilities unattached and unencumbered?

RESPONSE:

1. The cash working capital study referred to above is an annual cash working study prepared as part of the rate making process. That study does not consider the daily fluctuations in the cash provided or used by the utility. There are daily and seasonal peak working capital fluctuations when the cash needs can exceed the cash generated by the utility, however when viewed annually, those fluctuations are more balanced. The short-term working capital loan is intended to provide Aquila access to cash to cover the daily peak requirements. In addition, the cash working capital study referenced above does not consider cash needs related to timing of cash required for payment of higher gas costs than currently factored into revenue. In a time of increasing gas costs, there can be a timing delay through the PGA process that requires the Company to have access to cash on a temporary basis.

2. As explained above, the working capital loan is structured to cover all of Aquila's utility operations including those jurisdictions whose annual working capital calculations are negative but encounter daily peak fluctuations and require access to short-term working capital funds.

ATTACHMENT: None

ANSWERED BY: Carol Lowndes

JUL 11 2003

AQUILA, INC.
CASE NO. EF-2003-0465
DATA REQUEST NO. MPSC-5003

DATE OF REQUEST: June 25, 2003

DATE RECEIVED: June 25, 2003

DATE DUE: July 15, 2003

REQUESTOR: Dave Sommerer

QUESTION:

A. Please indicate, by state, whether a provision for carrying cost exists with regard to purchased gas cost collections. Please provide a copy of the provision that authorizes such treatment for each state.

B. Please indicate the regulatory treatment of natural gas inventory, by state, for each local gas distribution company operated by Aquila. Please provide copies of the most recently filed ratebase amounts for gas inventory from the various state rate cases.

C. Please indicate the regulatory treatment of natural gas inventory, by state, for each electric company operated by Aquila. Please provide copies of the most recently filed ratebase amounts for gas inventory from the various state rate cases.

RESPONSE:

A. Missouri, Colorado and Michigan all have carrying cost provisions. The Missouri Carrying Cost provisions are set forth in Sheet No. 36 of Aquila's Missouri Gas Tariff, which Aquila trusts is already available to the Staff. Colorado and Michigan are attached.

B. Gas in Underground Storage is a rate base item. Balances are attached.

C. Aquila has investments in electric properties in Missouri, Kansas and Colorado. Gas is bought on a daily basis, therefore no gas inventory is included in ratebase for any of our electric jurisdictions.

It should be noted that Aquila is not proposing rate recovery for the balances included in the working capital study; only the ability to pledge certain assets in order to provide access to the necessary cash on a short -term basis. The working capital study was conducted to determine the maximum single peak day need to ensure sufficient cash would be available for daily liquidity purposes. Rate relief for items included in the working capital study are normally determined through a lead lag study or a calculation of certain rate base items which are calculated on an average number of days or an average for the year, not a single peak day need.

ATTACHMENT: Gas rate case rate base pages are attached (hard copy).

ANSWERED BY: Steve Jurek

AQUILA, INC.
CASE NO. EF-2003-0465
DATA REQUEST NO. MPSC-27

DATE OF REQUEST: May 30, 2003

DATE RECEIVED: May 30, 2003

DATE DUE: June 19, 2003

REQUESTOR: Joan Wandel

QUESTION:

Given that the Missouri assets, in their entirety, are sufficient to meet the collateral obligations of the $250 million portion of the $430 million three-year Term Loan, what safeguards have been put in place to ensure that the assets from all the domestic utility operations which are granted approval by their state commissions to pledge their assets for the purposes of this loan will be included on a pro-rata basis as pledged assets to replace the Canadian properties and that the Company would not pledge:

1. Only the Missouri assets or
2. A disproportionate amount of Missouri assets?

RESPONSE:

First, the Company has already pledged its utility assets in Nebraska and Michigan to the $430 million Term Loan. Moreover, the Company does not intend to replace the existing security arrangements with only the Missouri assets. Aquila has also filed in Colorado, Minnesota, Iowa, and Kansas for approval to pledge its assets in each of those states to the $430 million Term Loan. In terms of "safeguards", Rick Dobson states on page 11 of his Direct Testimony the Company's objective of pledging all of the states to the $430 million Term Loan. Aquila plans on pledging its regulated assets to the Term Loan once it receives the appropriate approvals. If one or a number of state's do not grant their approvals, then there will be a disproportion between the state assets pledged and the percentage of the working capital facility used to support Aquila's utility operations in those states. Second, we have been advised that Aquila cannot partially mortgage a state utility property(i.e. an individual cannot mortgage only a room in their house). As explained by Rick Dobson in his testimony, the entire state utility property would be mortgaged but only a portion is needed to support the loan. If Aquila is successful in receiving approvals from all states, the loan will be over-collateralized.

ATTACHMENT: NA

ANSWERED BY: Mike Cole

AQUILA, INC.

SUPPLEMENTAL TESTIMONY

of

RICK DOBSON

PUBLIC VERSION

In re Aquila, Inc.
Docket No. SPU-03-7

July 18, 2003

Schedule TJR-23.1

b. What the implications (if any) of Fitch's perspective, especially as it might impact Aquila's restructuring plans?

A. Aquila does not have the details and assumptions utilized by Fitch in its analysis. Each of the rating agencies view and calculate "off balance sheet" obligations differently and generally do not share the details of those calculations. As such, we cannot opine on the reasonableness of their analysis and conclusions that can be drawn from their analysis.

We have not seen the details supporting Fitch's enterprise valuations but those valuations are often quite complex. Fitch's valuations imply that Aquila's common stock has no value, and that is contradictory to the positive value the market has placed on our shares of common stock. Presumably, any implications of Fitch's analysis have already been reflected in their assessment of Aquila's credit quality.

Q. Would or should any pledging of the utility assets in Iowa for security on a subsequent loan require another application before the Board? Also, please explain if any approval of pledging utility assets should be restricted to just the current loan.

These responses are requested in the Board's request **<u>number 43</u>**.

A. Aquila requested authority from the Board to extend or rollover the existing term loan partially secured by Iowa assets in order to maintain continuity in its financial liquidity, avoid creating another "financial deadline" where the lenders have a negotiating advantage, and provide a longer term outlook for financial stability for our employees, suppliers, customers, and shareholders. The creation of a longer-term horizon of financing certainty enables our employees to see that their careers with Aquila are viable and enhances our ability to retain the dedicated employees that are currently supporting the utility operations. If this Board and other Commissions deny this application to secure debt, more uncertainty will be created in the marketplace. By granting this application, Aquila will be placed in a stronger, long term financial position and can focus on the effective execution of its restructuring plan rather than having to be distracted by the complexities and uncertainties involved in starting the entire debt securitization process all over again.

Q. Does this complete your testimony?

A. Yes it does.

STATE OF MINNESOTA
BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

LeRoy Koppendrayer	Chair
Marshall Johnson	Commissioner
Phyllis Reha	Commissioner
Gregory Scott	Commissioner

In the Matter of a Request by Aquila, Inc. for Authority to Use Aquila Networks-PNG and Aquila Networks-NMU Utility Property To Secure Indebtedness	MPUC Docket No.: G007,011/S-03-681

AQUILA, INC. REPLY COMMENTS

These Reply Comments are submitted by Aquila, Inc. and its Divisions Aquila Networks-PNG and Aquila Networks-NMU ("Aquila"), in response to the Minnesota Department of Commerce ("Department") June 30, 2003 Comments concerning Aquila's request to encumber its Minnesota utility property to secure the payment of $250 million of a $430 million loan and to secure future replacement debt offerings for working capital requirements. The Department recommends that the Minnesota Public Utilities Commission ("Commission") deny Aquila's request absent a showing in these Reply Comments that:

1. ratepayers will not assume responsibility for debts that were incurred to support nonregulated businesses; and
2. the encumbrance is in the public interest.

(Department Comments, p. 3.) The Department also stated that the "Supplemental Direct Testimony" filed by Aquila on June 18, 2003 was not considered in developing its recommendation and that Aquila could include this information in these Reply Comments (Department Transmittal Letter). These Reply Comments will address these issues and will demonstrate that Aquila's request, as conditioned below, should be approved.

I. Ratepayers Will Not Assume Responsibility For Debts Incurred To Support Nonregulated Businesses.

The Department is concerned that Aquila's proposal, once certain unregulated assets are sold, requires ratepayers to assume responsibility for debts incurred to support nonregulated businesses because the $430 million debt might not "waterfall' down as the unregulated properties are sold. While Aquila has always intended to segregate the use of the secured debt to support regulated and nonregulated operations, it is clear from the Department's Comments that a more concise statement of how that will occur, including a commitment to reduce debt as non-regulated assets are sold is needed. Therefore, Aquila makes the following commitment to address this concern:

> The amount of Term Loan Facility secured for utility operations will not exceed $250 million (unless a subsequent Aquila request is approved by the Commission authorizing an increase in utility working capital (e.g. because gas costs have increased). To the extent that the Term Loan Facility is used for both utility and non-utility operations, the amount of debt used for non-utility operations will be secured by sufficient non-utility assets (at a ratio of at least 1.67 to 1). The amount of the non-utility debt will be reduced as necessary to meet this commitment.

The Department reached its conclusion based upon an analysis of the collateral available to support the $430 million Term Loan Facility. The testimony from Aquila's Chief Financial Officer, Rick Dobson , states that Aquila has internally separated the $430 million into two components: $250 million to support the ongoing working capital requirements of the domestic utility business and $180 million to support the non-utility businesses. Aquila also testified that: "It is Aquila's intent to maintain a proper alignment of domestic utility collateral with domestic utility loan needs and nondomestic utility and nonregulated business collateral with their loan needs." (Dobson, page 11, lines 1-3.)

It appears that both Aquila and the Department agree on what the intent should be but the actual execution of that intent needs clarification. The needed clarification is a description of what will happen when Aquila sells nonregulated and international utility collateral. In that case, the $430 million loan will be reduced, as necessary, to maintain the alignment stated in Mr. Dobson's testimony. That is, the $250 million needed by the domestic utility will be secured by utility collateral and the $180 million will be reduced to reflect the available nonregulated collateral. If no nonregulated business collateral is available, the portion of the Term Loan Facility not supporting the utility operations would be reduced to zero. If sufficient utility collateral is not available to secure the working capital needed by the utility, it would also have to be reduced to meet the collateralization ratio requirement.

As the Department recommends (page 9), the loan will be "waterfalled" down to an amount less than $430 million to reflect the available nonregulated collateral. Regulated assets <u>will not be used</u> to support a credit facility for use by nonregulated operations. Aquila <u>agrees not</u> to use the encumbered regulated assets in order to use a credit facility to buy back debt that was created by Aquila to pay for its various nonregulated activities. The Department's concern about violating the principal of separation will not happen.

These additional commitments, along with Aquila's earlier commitments to use a hypothetical cost of capital and investment grade debt costs in future rate cases demonstrate that ratepayers will not assume responsibility for, or the costs of, debt incurred to support nonregulated businesses.

II. The Encumbrance Is In The Public Interest.

The Department stated that the "litmus test" for its recommendation is whether approval is in the public interest. In making its initial determination, the Department identifies two benefits resulting from the Term Loan Facility:

1. As unregulated assets are sold, the $180 million portion of the Term Loan Facility previously used for the cash working capital needs of the nonregulated activities would be used to replace more expensive outstanding Aquila debt.

2. If the State Commissions allow utility property to be used to secure the debt, a 75 basis point reduction in the interest rate on the Term Loan Facility will occur (decreasing interest expense by $3.2 million a year).

The Department's Comments also addressed two potentially related matters: 1) the Department concludes that the Company may not be able to meet its principal and interest requirements; and 2) the Department noted that the lenders could acquire the utility assets without proceeding through bankruptcy. While the Department did not specifically list these issues as a reason for denying the application, the Company will respond to these observations made by the Department to ensure that the record is complete.

A. The Debt Issuance Is In The Public Interest Because It Provides The Working Capital Needed For Utility Operations.

The encumbrance of utility property to secure debt is routinely required by lenders as a condition of making capital available, and adds no additional risk. Therefore, the appropriate concern should not be whether the debt is secured, but rather, whether the debt is: a) needed for utility operations; and b) provided at a reasonable cost. The Department has not challenged either the need for, or the cost of, the debt.

The Department reviewed the Working Capital Requirements Study (Study) prepared by Aquila. The Study was developed to quantify Aquila's utility working capital needs. "The Department reviewed the Study and found it to be reasonable. Further, the Department's review of the Study determined that the assumptions used are reasonable" (Comments, p. 7). Because both Aquila and the Department agree that working capital is needed, the issuance of debt in the requested amount for that purpose is in the public interest.

With respect to the cost of this debt, Rick Dobson's Direct Testimony, page 13, lines 15, through page 14, line 3, explains that the $430 million Term Loan Facility will be maintained at the corporate level and the funds will be used as if a revolver existed. That is, Aquila will function as the bank for its utilities' cash working capital needs. A utility will only be charged for use of funds for the period of time when working capital is actually provided, and the cost of the funds actually used by the utility will be based upon the cost of debt to a BBB investment grade utility. The difference between the investment-grade cost and the actual cost of the debt will be retained at the corporate level – effectively sheltering utility customers from the cost of working capital if that cost exceeds investment grade levels. In this manner, Aquila is attempting to replicate how an investment-grade utility would meet the cash needs of its utility business. Consequently, the Term Loan Facility would not be included in the capital structure of either Aquila Networks-PNG or Aquila Networks-NMU. .

B. The Debt Issuance Is In The Public Interest Because It Will Help Aquila Return To Its Prior Status As An Investment Grade Utility.

The $430 million debt issuance is an integral part of Aquila's plan to return to an investment grade utility. Becoming an investment grade utility is in the public interest because utilities need access to large amounts of capital to assure safe, reliable and affordable service. While Aquila can meet those needs in the short-run without being an investment-grade utility, it would, over time, become increasingly more difficult and expensive.

The "Recommended Decision of Administrative Law Judge Dale E. Isley approving Stipulation and Settlement Agreement" for the State of Colorado, at paragraph 16, makes the following finding concerning the relationship of the debt issuance and the goal of becoming an investment grade utility:

> The parties believe that granting the application, subject to the terms of the Stipulation, is in the public interest. Having reviewed the Stipulation, the application, the prefiled testimony and exhibits submitted by Aquila in this matter, and the testimony presented by the parties at the hearing, the undersigned agrees. Subject to the conditions contained in the Stipulation, approval of the pledge of Aquila's Colorado utility assets to secure the loan will greatly assist Aquila's efforts to implement the Financial Plan and, ultimately, should serve to

return it to a capital structure reflective of a gas and electric utility and to restore its debt rating to investment grade.

The Colorado Administrative Law Judges' ("ALJ") recommended decision approving the encumbrance application became final on July 10, 2003 and a copy is attached to this filing. Jon Empson's Supplemental Direct Testimony (which was filed before the ALJ issued his recommendation) included a copy of the referenced Stipulation. As stated on page 4, line 3, of that Testimony, Aquila has accepted the conditions outlined in the Colorado Stipulation for application in Minnesota.

The Department made an observation that the Company might not be able to generate sufficient cash flow to meet its future debt payment requirements. The relationship of this observation and Aquila's request for approval of the debt issuance is unclear. The direct purpose of the secured debt at issue in this application is to provide the cash needed to meet peak cash working capital requirements. It is an important piece of the overall plan designed to return Aquila to an investment-grade utility. It helps Aquila meet its operational needs and consequently reduces, not increases, the risk of default or bankruptcy. The following discussion provides further information on actions Aquila is taking to meet its goal of returning to an investment grade utility.

First, the Company would like to correct an apparent typographical error on page 6 of the Department's Comments. Aquila's share of the sale of Sterling Ltd. Joint venture is expected to be closer to $46 million rather than "14 million" as stated in the first paragraph. However, correcting that typographical error does not remedy the Department's concern. In response to that concern, the Company offers four observations:

1. Denial of the Aquila's application could result in higher debt costs and less access to needed utility working capital, which would increase, not lessen the Department's concerns.

2. The analyses being completed by external parties and referenced by the Department are based upon publicly available information. Not included in those analyses, for example, is the fact that Aquila is in the process of filing a series of rate case requests in Missouri, Nebraska, and Colorado that will exceed $100 million annually. These requests are based upon the cost incurred to provide safe and reliable service to our utility customers in those states and <u>do not</u> reflect any cost derived from Aquila's nonregulated businesses or current financial position. While Aquila cannot predict the specific outcome of these rate cases, the Company stands behind the legitimacy of its filings.

3. When Aquila developed its Financial Plan, it attempted to be realistic, yet conservative, in its assumptions about the timing, extent, and the value of the asset sales. The experience so far has been that Aquila has moved faster and with better economic results than the Plan had originally anticipated.

4. The Financial Plan, by design, is not a static document and will be continually refreshed in order to ensure a successful transition back to an investment grade utility company. Assuming that the Department's observation is correct and Aquila will continue to have a significant amount of residual debt to support even after the nonregulated and international assets are sold, there are four sources of support for that debt. The debt secured by Minnesota utility property will not be used for that purpose. First, the Company will not restore a shareholder dividend payment until an appropriate capital structure has been developed. Therefore, the cash flow that would have gone to shareholders will be used to service the debt. Second, Aquila is preparing an application that will be filed with FERC to issue convertible debt. This debt will be used to retire existing debt, will have a lower cost and will be convertible to equity. The benefits are that Aquila's interest costs are lowered initially because the convertible rate is lower than the current embedded cost of debt and when the debt is converted to equity, the related interest cost

is eliminated. Third, the Company also intends to issue new equity, if market conditions are favorable. The proceeds from the new equity offering will be used to retire debt. Both the convertible debt and equity filings will be essentially "shelf registrations," to be executed when market conditions are right. Finally, if the Company is successful in gaining State Commission approvals of its encumbering applications, the interest rate on the $430 million debt will decrease by .75%, decreasing interest expense by $3.2 million a year.

Aquila has a sound plan to restore financial stability in a manner that protects Minnesota customers from adverse operational or financial impacts.

C. Using Utility Property To Secure Debt Does Not Increase Ratepayer Risk.

The Department states (page 10): "In sum, the risk for the ratepayers does not appear to be any greater with encumbrance than without encumbrance in bankruptcy." In fact, issuance of debt needed for operational needs at a reasonable cost decreases rather than increases the risk of bankruptcy or default. The Department also states that, in the event of a default outside the context of a bankruptcy, the lenders could take possession of the assets without a bankruptcy proceeding. While that is technically possible, in the event of a default, the Company would itself file for bankruptcy. In any event, pursuant to Minn. Stat. § 216B.50, the lenders acting directly could not obtain or in any dispose of the assets without prior Commission approval. Section 216B.50 states in part: "No public utility shall sell, acquire, lease, or rent any plant as an operating unit or system in this state . . . without first being authorized so to do by the Commission."

Securing debt affects the comparative rights of the debtors. It does not change any regulatory requirements, or affect the rights of ratepayers. The reason utilities grant security interests to lenders is because doing so increases the availability of capital and lowers the cost of the debt. Because granting a security interest increases the availability of capital and lowers the cost of debt, it is common for utilities to have at least some secured debt. Rick Dobson's Direct Testimony, page 14, lines 12-26, and Exhibits 5 and 6, discusses the use of secured debt by utilities. The Supplemental Direct Testimony of Jon Empson documented that Minnesota Power, Excel Energy, Otter Tail Power, and Interstate Power and Light Company have all issued debt secured by their Minnesota utility property.

In its 10-K for fiscal year ended December 31, 2002, Allete, Inc. (parent of Minnesota Power) states: "Substantially all of our electric plant is subject to the lien of the mortgages securing various first mortgage bonds." See Attachment A to Jon Empson's Supplemental Direct Testimony. Minnesota Power's reliance on secured debt is further detailed in its Capital Structure Petition, Docket No. E015/S-02-161(approved by Commission Order dated April 10, 2002,), Exhibit H, which is included as Attachment B to Jon Empson's Supplemental Direct Testimony. Exhibit H lists $601,000,000 of First Mortgage Bonds that are secured with "MP Utility Property."

Xcel Energy's Capital Structure Filing, Docket No. E,G002/S-02-1907 (approved by Commission Order dated January 13, 2003), Attachment I, lists $818,915,000 of secured First Mortgage Bonds. Xcel also indicates that more than $155,215,000 of previously unsecured debt has been converted to secured debt since 1997. See Attachment C to Jon Empson's Supplemental Direct Testimony.

Otter Tail Power's Capital Structure Filing, Docket No. E017/S-02-49 (approved by Commission Order dated April 3, 2002), Attachment 6, lists $64,200,000 of First Mortgage Bonds. Otter Tail, in discussing potential First Mortgage Bonds that may be issued and sold in 2002 ("New Bonds"), states: "The New Bonds will be, generally speaking, secured by a first mortgage on all of the fixed properties of the Company, and will be on a parity with the other

First Mortgage Bonds of the Company, the terms of which are described generally on Attachment No. 6. ..." See Attachment D to Jon Empson's Supplemental Direct Testimony.

Interstate Power and Light Company's Capital Structure Filing, Docket No. G,E001/S-02-308, (approved by Commission Order dated April 24, 2002) lists First Mortgage Bonds outstanding of $139,000,000. See Attachment E to Jon Empson's Supplemental Direct Testimony.

While corporate organizational differences may exist between Aquila and utilities like Xcel Energy, which is able to issue stand alone debt, Aquila's commitment to use adequate non-regulated property to secure any debt used for non-utility operations provides adequate ratepayer protection.

III. Conclusion.

The request to encumber Minnesota regulated assets should be approved by the Commission:

- It is in the public interest.
- Ratepayers will not assume responsibility for debts incurred to support nonregulated businesses.

The amount of Term Loan Facility secured for utility operations will not exceed $250 million (unless a subsequent Aquila request is approved by the Commission authorizing an increase in utility working capital (e.g. because gas costs have increased). To the extent that the Term Loan Facility is used for both utility and non-utility operations, the amount of debt used for non-utility operations will be secured by sufficient non-utility assets (at a ratio of at least 1.67 to 1). The amount of the non-utility debt will be reduced as necessary to meet this commitment.

Aquila appreciates having the opportunity to provide additional information in response to the Department's Recommendations and intends to immediately pursue further discussions with the Department to determine if the clarifications/commitments provided adequately address the Department's concerns.

Dated: July 15, 2003

Respectfully submitted,

By ______________________________
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AQUILA, INC.
CASE NO. EF-2003-0465
DATA REQUEST NO. OPC-5008

DATE OF REQUEST: July 3, 2003

DATE RECEIVED: July 3, 2003

DATE DUE: July 23, 2003 **Supplemented 9/2/03.**

REQUESTOR: Douglas E. Micheel

QUESTION:

Please provide complete copies of any and all testimony, recommendations, or comments filed in the Minnesota docket G007, 011/S-03-681.

RESPONSE: Please see attached.

ATTACHMENT: Copies of comments filed by staff of Minnesota Department of Commerce and Minnesota Attorney General.

ANSWERED BY: Mark Reed