EXHIBIT

Exhibit No.:	
Issue(s):	Financial Impact
Witness:	Mark Burdette
Type of Exhibit:	Rebuttal
Sponsoring Party:	Public Counsel
Case No.:	EF-2003-0465

REBUTTAL TESTIMONY

OF

MARK BURDETTE

FILED

DEC 0 5 2003

Submitted on Behalf of
the Office of the Public Counsel

AQUILA, INC.

Case No. EF-2003-0465

September 10, 2003

Exhibit No. 31
Case No(s). EF-2003-0465
Date 10-30-03 Rptr

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of the Application by Aquila, Inc. for authority to assign, transfer, mortgage or encumber its franchise, works or system.	)))	Case No. EF-2003-0465

AFFIDAVIT OF MARK BURDETTE

STATE OF MISSOURI)
) ss
COUNTY OF COLE)

Mark Burdette, of lawful age and being first duly sworn, deposes and states:

1. My name is Mark Burdette. I am a Financial Analyst for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my rebuttal testimony consisting of pages 1 through 21 and Schedules MB-1 through MB-5.

3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

____
Mark Burdette

Subscribed and sworn to me this 10th day of September 2003.

____
Kathleen Harrison
Notary Public

My commission expires January 31, 2006.

REBUTTAL TESTIMONY

OF

MARK BURDETTE

AQUILA, INC.

CASE NO. EF-2003-0465

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Mark Burdette, P.O. Box 7800, Jefferson City, Missouri 65102-7800.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by the Office of the Public Counsel of the State of Missouri (OPC or Public Counsel) as a Public Utility Financial Analyst. Also, I am an adjunct faculty member with Columbia College. I teach undergraduate Business Finance and graduate-level Managerial Finance.

A. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND.

Q. I earned a Bachelor of Science in Electrical Engineering from the University of Iowa in May 1988. I earned a Master's in Business Administration with double emphases in Finance and Investments from the University of Iowa Graduate School of Management in December 1994.

Q. PLEASE DESCRIBE YOUR CONTINUING EDUCATION.

A. I have attended various regulatory seminars presented by the Financial Research Institute, University of Missouri-Columbia and the National Association of State Utility Consumer Advocates. Also, I attended The Basics of Regulation: Practical Skills for a Changing Environment presented by the Center for Public Utilities, New Mexico State University.

Q. DO YOU HAVE ANY PROFESSIONAL AFFILIATIONS?

A. Yes. I am a member of the Society of Utility and Regulatory Financial Analysts (SURFA).

Q. DO YOU HOLD ANY PROFESSIONAL DESIGNATIONS?

A. Yes. I have been awarded the professional designation Certified Rate of Return Analyst (CRRA) by the Society of Utility and Regulatory Financial Analysts. This designation is awarded based upon work experience and successful completion of a written examination.

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION (MPSC OR THE COMMISSION)?

A. Yes.

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. I will present testimony regarding Aquila, Inc.'s (Aquila, the Company) request to use regulated utility assets within the state of Missouri as part of a collateral pool to secure new or existing debt instruments, including the Company's already-acquired $430 million Term Loan Facility (TLF). I will address certain financial concerns regarding Aquila's request to encumber Missouri-regulated utility assets.

Q. DO YOU HAVE SCHEDULES ATTACHED TO YOUR DIRECT TESTIMONY IN SUPPORT OF YOUR POSITIONS?

A. Yes. There are five schedules attached to this testimony:

<u>Schedule MB-1</u>:
Comments of the Minnesota Department of Commerce Before the Minnesota Public Utilities Division Docket No. G007,011/S-03-681;

<u>Schedule MB-2:</u>
Aquila, Inc. Reply Comments to the Minnesota Department of Commerce's initial comments Docket No. G007,011/S-03-681;

<u>Schedule MB-3:</u>
Additional Comments of the Minnesota Department of Commerce Docket No. G007,011/S-03-681;

<u>Schedule MB-4:</u>

Aquila, Inc. Reply Comments to the Minnesota Department of Commerce's additional comments Docket No. G007,011/S-03-681;

Schedule MB-5:
"POWER POINTS: Back-To-Basics May Not Pay Aquila's Bills." *Wall Street Journal Online*, August 22, 2003.

Q. IS AQUILA, INC. AN INDEPENDENT, PUBLICLY TRADED COMPANY?

A. Yes. Aquila, Inc. is a public utility with common stock and long term debt issued in its name. The common stock of Aquila trades on the New York Stock Exchange under the ticker symbol ILA.

Aquila's Current Financial Condition Due To Unregulated Operations

Q. WHY IS AQUILA IN ITS CURRENT WEAKENED FINANCIAL STATE?

A. Aquila's current weakened financial condition is due to the Company's **unregulated** operations. The Company's regulated utility assets have continued to earn a positive return and have not contributed to the weakened condition.

Q. DOES AQUILA CONFIRM THAT THE MISSOURI REGULATED UTILITIES HAVE EARNED A POSITIVE RETURN?

A. Yes. In informal interviews that took place on 16 July 2003, the following exchange took place between Public Counsel witness Ted Robertson and Aquila employees Beth Armstrong, Rick Dobson and Jon Empson (page numbers refer to the transcripts of the interviews):

> Page 452
> 25 MR. ROBERTSON: It does. Actually, the
> Page 453
> 1 last question I have on this number 5 is, as
> 2 far as the Missouri regulated utilities are
> 3 concerned, are they on -- as far as net
> 4 operating income, are they on a positive
> 5 basis?
> 6 MR. DOBSON: Yes, they are.
> 7 MR. ROBERTSON: Positive net operating
> 8 income they're generating?
> 9 MR. DOBSON: They do generate positive

> net operating income.
> <u>MR. ROBERTSON</u>: Can you tell me the last time they were negative on an annual basis?
> <u>MS. ARMSTRONG</u>: In terms of a net loss for an annual basis, I don't recall.
> <u>MR. DOBSON</u>: I don't recall.
> <u>MS. ARMSTRONG</u>: They're under earning in terms of what the targeted return would be in a significant way, but they are earning positive net income.
> <u>MR. ROBERTSON</u>: All right. I understand. Maybe the rate of return that you expect you're not achieving, but to your knowledge when was the last time that the net operating income of the Missouri regulated utilities was negative?
> Page 453
> <u>MR. EMPSON</u>: Denny had to step out. If we could hold on to that, he'll be back here in about a half hour and we can ask him. He probably has more long-term value with that.
> <u>MR. DOBSON</u>: Jon, I've been around with the Company since 1989, and I don't ever recall, but my memory is not that gone, never recall net operating income being negative since 1989.
> <u>MR. ROBERTSON</u>: That's good enough. In the near term, it hasn't occurred. We don't got to go back to 1905.

Q. DOES THE COMPANY ADMIT THAT ITS UNREGULATED OPERATIONS ARE THE REASON FOR ITS CURRENT FINANCIAL CONDITION?

A. Yes.

Q. HAS AQUILA ADMITTED IN THIS PROCEEDING BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION THAT ITS CURRENT FINANCIAL CONDITION IS DUE TO UNREGULATED OPERATIONS AND NOT DUE TO ITS REGULATED UTILITY OPERATIONS?

A. Yes. In his Direct Testimony Rick Dobson, Aquila's Senior Vice President and Interim Chief Financial Officer, commenting on Aquila's investments in unregulated operations, states:

> First, it is important to state that Aquila assumes total responsibility for its strategy. We chose to embark on this journey into merchant and

> telecommunications businesses. While many external factors in 2002 influenced our ability to continue to execute our strategy, the choice to enter those businesses was clearly ours. (Page 6)

Also, in informal interviews that took place on 16 July 2003, the following exchanges took place between Michael Gorman, consultant for SIEU and Aquila employees Beth Armstrong and Steve Fisher:

> Page 76
> MR. GORMAN: No, I'm waiting for her to find it. If I look at total company, there's
> Page 77
> a long-term debt reduction, **but if you look at just utilities, there is no debt reduction.**
> So the first question is am I correct that that debt reduction is for companies that are not regulated utilities?
> MS. ARMSTRONG: Steve, you'd be better to answer that.
> MR. FISHER: That's correct. If you look at the projections for the domestic networks or our utility on a stand-alone basis, it's capitalized on a 50-50 debt to equity structure roughly.
> **So the excess leverage is due to the non-regulated or corporate parent,** whatever you want to call it. And so as we continue to sell assets and pay down debt, then that would be reflective on the consolidated statements, not the domestic networks.

Q. HAS AQUILA ADMITTED IN OTHER REGULATORY JURISDICTIONS THAT IT WAS THE COMPANY'S UNREGULATED OPERATIONS THAT LED TO ITS CURRENT FINANCIAL CONDITION?

A. Yes. Aquila is also seeking authority to encumber its regulated utility assets in the state of Iowa (Docket No. SPU-03-7). In that proceeding, testimony was filed by Gregory Vitale on behalf of the Iowa Office of Consumer Advocate. As part of Mr. Vitale's testimony, he included work papers that contain data requests sent to Aquila. Following is the information from data request No. OCA-8, dated May 14, 2003, and the response by Mr. Rick Dobson of Aquila.

> Question: Is it your testimony that regulated utility operations led to credit downgrades, dramatic reductions in stock value and major efforts to restructure corporate operations? Provide all research, analysis, articles and any other support relied upon in your response.
>
> Response: **No, the regulated utility operations of Aquila did not lead to the credit downgrades and reduction of stock valuation. This came about as the Company was force to hastily exit its merchant trading business and sell related assets** to comply with the new stricter credit guidelines established for merchant companies by the credit agencies, post the Enron collapse. See the reports by Standard & Poor's and Moody's attached in the response to OCA-9 for further explanation. [Emphasis added]

Aquila is also seeking to encumber its Minnesota-jurisdictional regulated utilities. In that case, Docket NO. G007,011/S-03-681, the document entitled "Comments of the Minnesota Department of Commerce," (Schedule MB-1) states:

> **According to Aquila,** the Term Loan Facility is needed due to the Company's particular financial difficulties and the financial difficulties and requirements of the energy sector at large. Prior to the difficulties experienced by companies in the energy sector, Aquila was a diversified utility. The Company owned:
>
> * Domestic and international utility assets;
> * Merchant services (including wholesale energy and risk management services);
> * Other energy industry investments (including electric generation, gas storage and gathering facilities); and
> * Telecommunications operations.
>
> The Company states that as a result of the Enron Corporation's perfidy and the uncertainty resulting from the California energy crisis, creditors began to have concerns about the financial conditions **of merchant energy companies.** Thus, Moody's Investor Service (Moody's) and Standard and Poor's Corporation (S&P) developed **more stringent credit guidelines for marketing and trading companies.**[4] Specifically, Moody's and S&P were looking for merchant companies to have operating cash flow and/or access to additional liquidity substantially beyond traditional levels.
>
> **These guidelines raised the requirements for liquidity and balance sheet strength for merchant companies that Aquila could not meet nor sustain on an ongoing basis.** Consequently, on August 2, 2002, the

> Company made the decision to voluntarily exit the merchant business. This decision left the Company with many stranded assets, which contain significant residual risk. Also, as Aquila attempted to shore up its balance sheet in the face of the energy-wide credit crunch, the Company was forced to sell many assets into a "buyer's" market, which resulted in sizeable book losses.
>
> **According to the Company, the deteriorating market conditions forced Aquila to violate certain interest coverage ratio covenants in the bank credit revolver.** In the process of negotiating a new credit revolver and gaining a waiver of the covenant violation for the banks, Aquila had to agree to several conditions, including a commitment to make a reasonable effort to gain state regulatory approval to secure a new credit revolver with utility assets. This instant petition constitutes the Company's efforts to secure the Commission's approval to encumber Minnesota regulated assets.
> ([4]**Aquila Merchant Services became one of the largest providers of wholesale energy and risk management services in North America**. Aquila ceased merchant operations after August 2, 2002.)
> ***(Emphasis added)***

Q. DID THE COMPANY REPLY TO THE MINNESOTA DEPARTMENT OF COMMERCE COMMENTS?

A. Yes. The Company filed a document entitled "Aquila, Inc. Reply Comments" (Schedule MB-2). This document is Aquila's reply to The Minnesota Department of Commerce's **Initial** Comments. I will also later reference Aquila's Reply Comments to the Minnesota Department of Commerce's **Additional** Comments.

Q. DID AQUILA ATTEMPT TO REBUT THE DEPARTMENT'S CHARACTERIZATION OF HOW AQUILA REACHED ITS CURRENT FINANCIAL CONDITION OR DENY THAT THE COMPANY'S UNREGULATED OPERATIONS WERE THE REASON FOR ITS CURRENT FINANCIAL CONDITION?

A. No. Aquila responded to specific items in the Minnesota Department of Commerce's Initial Comments, but did not deny the characterization and reasoning as to why the Company is in the financial condition in which it currently finds itself.

Q. HAVE ARTICLES ABOUT AQUILA'S CURRENT WEAKENED FINANCIAL CONDITION APPEARED IN THE FINANCIAL PRESS?

A. Yes. An article in the Wall Street Journal Online, August 22, 2003, entitled "POWER POINTS: Back-To-Basics May Not Pay Aquila's Bills", states, in part:

> Maybe one reason you can't go back to the farm after having been to Paris is that you can't pay your Chanel and Gaultier bills on a farmer's income.
>
> That may be one lesson learned by Aquila Inc. (ILA), which is trying to return to its roots as a basic power and natural gas regulated utility in the Midwest.
>
> **The income from that line of business may not cover the cost of servicing leftover debt from almost $2 billion in poor investments in telecom, merchant energy and a British utility.** Regulators aren't going to let customers of Aquila's monopoly gas business back in Missouri, for example, pay for the company's unused merchant power plants.
>
> So, the company's future depends on its ability to sell assets at good prices to pay off debt and reduce interest costs as much as possible. Some analysts don't think it will work.
>
> "I don't see them digging out of the hole," and Bank of America Securities' debt analyst Craig Gilbert. "In our view they aren't going to generate enough free cash flow in the future to materially reduce debt, but the value of the assets should come close to the liabilities."
>
> Aquila executives admit that the road ahead is tough.
>
> "At this point, with our stock in the $2 range, we're like an option premium on how the divestitures come out," Aquila Chief Financial Officer Rick Dobson said in an interview.
>
> **Even after the company finishes selling noncore assets and negotiating discounts on some other obligations, it still will have some debt left over from its failed investments.**
>
> **"That leaves some overhang on our books," said Dobson. "Whether that's $100 million or $500 million, almost all debt holders are doing the math, and coming to their own conclusions."** [Emphasis added]

Current or Potential Detriments to Missouri Ratepayers

Q. HAVE THERE BEEN DETRIMENTS TO AQUILA'S MISSOURI RATEPAYERS DUE TO THE COMPANY'S DETERIORATED FINANCIAL CONDITION?

A. Yes. Because of the failure of Aquila's unregulated operations and the Company's deteriorated financial condition, Aquila must now prepay for natural gas. Previously, Aquila had the opportunity to take delivery of gas and then pay at a later date. This change has harmed the Company's Missouri ratepayers because the Company now does not have use of the cash it must prepay for gas. When the Company could take delivery and then pay, it did not have to expend that cash at that time. The necessity to prepay for gas supplies has decreased the financial flexibility of the Company. Also, because the cash must be expended at an earlier date, the Company has forfeited any benefits of the time value of money. Previously, even if the Company had no other use for the cash, it could potentially be placed in an interest-bearing financial instrument until it was needed. The necessity to prepay removes that ability.

Q. DOES AQUILA ADMIT THAT THE REQUIREMENT TO PREPAY FOR NATURAL GAS HAS A FINANCIAL IMPACT ON THE COMPANY?

A. Yes. Data request OPC-629, includes the question "Does Aquila believe that being required to prepay for natural gas supplies and pipeline transportation capacity is a detriment to Aquila?" Aquila's response, curiously, denies detriment but admits a financial impact: "No. While there is a financial impact on Aquila, it has not been detrimental to our ability to provide safe and reliable service to our customers."

Although the Company denies a *current* detriment, it admits a financial impact exists. As I have already discussed, there are indeed very real detriments in that the Company's financial flexibility has been decreased and the cash required for prepayment of gas is unavailable for other uses, including simple short-term, interest-bearing investments.

Q. DOES AQUILA ACKNOWLEDGE THE LOST OPPORTUNITIES FOR THE USE OF THE CASH REQUIRED FOR PREPAY AND ADMIT FINANCIAL HARM?

A. Yes. Following is the question posed in Public Counsel data request OPC-633 and part of Aquila's response:

> Question: If there are opportunity costs, please provide the Company's calculation of the opportunity costs.
> Response: Two methods of calculating opportunity costs would seem most appropriate. The incurrence of this opportunity cost is centered on **the fact that natural gas prepayment requirements temporarily reduce Aquila's cash balance.** The first method focuses on the investment rate currently earned on our cash balances and estimates the opportunity cost of foregoing this interest income during the prepayment period. If Aquila pre-pays $10 million one month in advance, **then the foregone interest income would be about $12,500.** A second method of estimating the opportunity cost is to calculate foregone economics of Aquila using the cash needed for the prepayment for other purposes. While the first example focused on short-term investments, this method assumes that the cash is invested at Aquila's overall cost of capital [8.16]% and [8.3]% for MPS and SJLP, respectively. If Aquila pre-pays $10 million one month in advance, **then the opportunity cost of using this method would be about $68,500.** [Emphasis added]

Q. HOW DOES THE REQUIREMENT FOR PREPAYMENT OF GAS AFFECT THE COMPANY'S REQUEST TO COLLATERALIZE MISSOURI-JURISDICTIONAL UTILITY ASSETS IN THIS PROCEEDING?

A. Aquila's request to collateralize Missouri-jurisdictional utility assets is based on the Company's analysis of peak-day working capital needs. Built-in to the Company's calculation of working capital requirements is the fact it must now prepay for gas. Absent the requirement to prepay for gas, the Company's working capital requirements would potentially not exist. Please refer to Public Counsel witness James Busch's testimony for a detailed analysis the Company's working capital needs and the requirement to prepay.

Q. CAN AQUILA'S NECESSITY TO PREPAY FOR NATURAL GAS BE COMPARED TO AN INDIVIDUAL WITH BAD CREDIT?

A. Yes. This situation can be compared to an individual with very bad credit. In cases of bad individual credit, the only "credit card" a person can get is a 'prepaid' card, which is also known as a secured credit card. This instrument requires the individual to have a prepaid cash balance on the card's account before it can be used for purchases, and purchases cannot exceed the amount of the cash balance. This situation is not technically credit in the sense of being able to buy now and pay later. It does enable the user to use a card in place of cash, for example, when purchasing goods though the mail. But the individual has to give up the use of the cash in order to have access to the card, and cannot spend more than the available cash balance.

As with Aquila, a secured card decreases an individual's financial flexibility. The cash balance placed on the card is not available for other uses, including not being available to earn interest in an interest-bearing account.

Q. AQUILA HAS CLAIMED THAT REGARDLESS OF THE ACTUAL DEBT COST IT MUST PAY IN THE OPEN MARKET, IT WILL CHARGE ITS UTILITY OPERATIONS A RATE THAT IS NO GREATER THAN WHAT A BBB (TRIPLE B) RATED UTILITY WOULD HAVE TO PAY. DO YOU AGREE THAT AQUILA'S REGULATED-UTILITY CUSTOMERS SHOULD PAY THE LOWER, INVESTMENT-GRADE RATE?

A. Yes, I do. Aquila's current below-investment grade credit rating, and the higher interest rates it must pay as a result, are due to the Company's unregulated operations. That additional interest expense should be paid by shareholders and not by regulated utility customers.

Q. IS IT CAUSE FOR CONCERN THAT AQUILA CLAIMS IT WILL CHARGE ITS REGULATED UTILITIES A LOWER INTEREST RATE THAN THE COMPANY CAN OBTAIN IN THE MARKET?

A. Yes. Aquila has stated that it intends to return to being a regulated utility, and eventually divest all unregulated operations. Because the Company does not have separate operating divisions that issue their own debt – **all** Company debt is at what Aquila calls "the corporate level" and is in Aquila's name. Therefore, Aquila must pay higher interest rates due to being rated below-investment-grade, but will (and rightfully so) "charge" lower, investment-grade interest rates to regulated utility customers. This disparity could – and probably will - mean the Company will experience a short-fall in cash and be unable to pay its debt. In short, the question is where will the additional cash flow come from to make up the difference between Aquila's actual debt costs compared to the costs that will be borne by the regulated utility operations?

Q. HAVE SOME OF AQUILA'S CUSTOMERS ALREADY SUFFERED DETRIMENT DUE TO THE COMPANY'S INCREASED RISK DUE TO UNREGULATED OPERATIONS?

A. Yes. Prior to being acquired by Aquila, St. Joseph Light & Power Company (St. Joe) had a credit rating of A- (A minus) from Standard & Poor's Credit Ratings Service. St. Joe's rating was placed on CreditWatch with negative implications at merely the proposal of the merger. After the completion of the merger, St. Joe's Missouri operations were combined with Aquila's, and also fell under the umbrella of Aquila's lower, BBB, credit rating. St. Joe's customers therefore faced an increased cost of future long-term debt with the reduction in credit quality.

Since the time of the merger, Aquila's financial condition and credit rating have deteriorated even further, leading directly to increased costs of debt for Aquila's St. Joe customers.

Q. CAN YOU BRIEFLY SUMMARIZE THE CONCERN REGARDING COST OF DEBT?

A. Yes. Aquila must pay high, non-investment-grade interest rates in the open market. It can collect lower, investment-grade interest expense from regulated utility customers. But, Aquila expects to have only regulated operations, so there will be a serious cash short-fall between what the Company can collect compared to what it must pay.

Q. HAS AQUILA CONFIRMED THAT IT INTENDS TO BE SOLELY A REGULATED UTILITY, THUS CONFIRMING THIS PROBLEM COULD EXIST?

A. Yes. From the informal interviews held 16 July 2003:

> <u>MR. BIBLE:</u> When you say US Utility business, what all would that include as far as regulated and non-regulated?
>
> <u>MR. EMPSON:</u> I think the ultimate end state, and this is the ultimate end state is the US regulated utility business, which is the gas, electric operations we have in seven states. Now, it's going to take some time to transition to that, but that is the -- from what I am hearing and Rick is nodding his head yes, that that is the ultimate end state.
>
> **<u>MR. BIBLE:</u> So the ultimate end state is to be all regulated and no non-regulated?**
>
> **<u>MR. DOBSON:</u> That's correct.**

Q. DO THE FINANCIAL MARKETS SIMILARLY RECOGNIZE THE POTENTIAL PROBLEM WITH AQUILA'S PLAN?

A. Yes. The financial markets are aware not only of the potential short-fall in cash for interest expense, but also a variety of other cash-draining financial arrangements Aquila is under. Again citing from the *<u>Wall Street Journal Online</u>* article, "POWER POINTS: Back-To-Basics May Not Pay Aquila's Bills":

> For debt allocated among Aquila's various local utilities, customers reimburse Aquila at interest rates of 7% to 8%, as if the company were still investment grade. In fact, Standard & Poor's rates it single-B, five steps below investment grade. The highest interest rate it pays – on a recent $500 million bond issue – is a whopping 14 7/8%.
>
> Aside from interest expense, Aquila for years to come has to spend more than $130 million annually buying natural gas for other utilities that have already paid Aquila. The company is also paying $37 million a year through 2015 for the right to generate power at a big merchant power plant in Illinois that can't make money in the current market. A similar long-term debt deal will start costing $21 million in 2006.

Q. DOES AQUILA ACKNOWLEDGE THAT OTHER PREPAYMENT REQUIREMENTS NOW EXIST IN ADDITION TO THE REQUIREMENT TO PREPAY FOR NATURAL GAS?

A. Yes. In response to Public Counsel data request OPC-635, Aquila provided the following response:

> In addition to natural gas supplies and pipeline transportation capacity, Aquila's U.S. Networks has had to make prepayments, collateral calls or provide letters of credit in such areas as purchased power, coal, construction support, workers compensation, reclamation of pit materials, and software support. Aquila also has had to provide letters of credit for its nonregulated operations.

Q. IS AQUILA ATTEMPTING TO COLLATERALIZE MORE UTILITY ASSETS THAN THE COMPANY IS REQUIRED BY TERMS OF THE LOAN AGREEMENT?

A. Yes. Please refer to Public Counsel witness Ted Robertson's Rebuttal Testimony for a detailed analysis of the level of utility assets the Company is required to collateralize compared to the actual level of collateral needed.

Q. IS THERE A POTENTIAL DETRIMENT IF AQUILA COLLATERALIZES ALL OF ITS REGULATED UTILITY ASSETS TO SUPPORT THIS SINGLE DEBT INSTRUMENT?

A. Yes. If Aquila utilizes all of its regulated utility assets to support this single $430 million Term Loan Facility, the Company will severely reduce its future financial flexibility by having no uncollateralized utility assets to support future potential debt issuances.

Q. DOES AQUILA BELIEVE THAT FINANCIAL FLEXIBILTY IS IMPORTANT?

A. Apparently so. According the Aquila's Reply Comments to the **Additional Comments** by The Minnesota Department of Commerce's in Minnesota Docket NO. G007,011/S-03-681, Aquila states:

> **Aquila needs the flexibility** to make the most cost effective decision in order to achieve financial stability. (page 4)
>
> 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. (page 5-6) [Emphasis added]

Q. DOES THIS ADMISSION ON THE PART OF AQUILA SUPPORT THE COMPANY'S DESIRE TO OVER-COLLATERALIZE THE $430 MILLION TERM LOAN FACILITY?

A. No, it does not. Aquila's comments and representations regarding the Term Loan Facility are fundamentally contradictory. On the one hand, before the Minnesota Public Utility Commission, the Company implores the need for the maximum level of financial flexibility. In this proceeding before the Missouri Public Service Commission, *as well as in the Minnesota case*, the Company is requesting over-collateralization. As I have already stated, over-collateralization will reduce the financial flexibility of the Company, period. It is simply untenable for Aquila to claim the need for financial flexibility while at the same time requesting over-collateralization of regulated utility assets.

Q. WHAT LEVEL OF REGULATED UTILITY ASSETS MUST AQUILA COLLATERALIZE TO SUPPORT THE $430 TERM LOAN FACILITY?

A. As detailed in Mr. Robertson's testimony, Aquila has represented that it will utilize $250 million of the $430 million loan for regulated operations, and must therefore collateralize 1.67 times that $250 million, or $417.5 million. The remaining $180 million of the TLF, if collateralized with unregulated assets, would require $360 million in unregulated collateral (two times the value of the loan amount). If the entire TLF were collateralized with regulated assets, it would take $718 million (1.67 times $430 million) in regulated assets to achieve that requirement.

Q. HAS AQUILA ALREADY ACQUIRED SUFFICIENT UTILITY-ASSET COLLATERAL TO FULFILL THE COLLATERALIZATION REQUIREMENT OF THE TERM LOAN FACILITY?

A. Yes. See Mr. Robertson's Rebuttal Testimony for details on the current status of collateralization.

Q. IS THERE A DETRIMENT TO MISSOURI'S RATEPAYERS IF AQUILA ENCUMBERS MISSOURI-JURISDICTIONAL REGULATED UTILITY ASSETS AND OVER-COLLATERALIZES THE TERM LOAD FACILITY?

A. Yes. Eventually, all of the TLF, and not just a portion, will be collateralized by regulated utility assets. **That means that Missouri regulated utility assets will be supporting debt that was acquired for and being used for *unregulated* operations.** That is detrimental to Missouri's ratepayers because regulated assets and/or debt should not be used to support higher-risk unregulated operations that do not provide utility service to those customers.

Q. HOW WILL THIS DETRIMENT, REGULATED ASSETS SUPPORTING UNREGULATED DEBT, TRANSPIRE?

A. This situation will come about if the TLF is over-collateralized with regulated assets and Aquila follows through with its plan to sell unregulated assets. It is based on the fact that Aquila can pay down the TLF without penalty **only** if the loan is collateralized exactly at the appropriate level, but the Company would be required to pay a penalty (called a Make Whole Premium) if it attempts to pay-down part of the TLF while that TLF is over-collateralized. This detriment is explained by Mr. Vincent C. Chavez, Supervisor, Natural Gas Planning and Advocacy, in the Document Additional Comments of the Minnesota Department of Commerce, Docket NO. G007,011/S-03-681:

> The definition of these two different prepayments is based on the level of collateralization of the $430 TLF. The following two examples should explain the distinction between "Optional" and "Mandatory" pre-payments.
>
> <u>Options Pre-payment:</u> The Company is required to maintain a collateral-to-debt ratio of 1.67 to 1; this is important to keep in mind. Thus, the minimum amount of collateral that is required for the $430 TLF is $718 million. So, for example, if Aquila had $900 million in assets securing the TLF, the Company could sell $100 million of the $900 million in collateral and not be obliged to pay down the $430 million TLF. The ratio of collateral would be $800 million to $430 million, or 1.86 to 1, still in excess of the minimum ratio of 1.67 to 1. Therefore, Aquila could use the $100 million to repurchase more expensive outstanding debt or whatever uses it had for this money. However, if Aquila decided to use the proceeds to pay back part of the $430 million debt, it would have to pay a significant pre-payment (a.k.a. "Make Whole Premium) penalty.

> <u>Mandatory Pre-payment:</u> If, on the other hand, Aquila only had the minimum amount of collateral required for the TLF, $718 million, then any proceeds from the sale of assets would have to be used to pay down, without penalty, the $430 million TLF and maintain the 1.67 to 1 ratio. So, for example, if Aquila had $718 million in collateral for the TLF and sold $100 million in assets, the collateral ratio would be $618 million to $430 million, or a ratio of 1.44 to 1. Thus, the bank would not allow Aquila to maintain the $430 million TLF because it would not be properly collateralized, according to the terms of the loan agreement. So for Aquila to maintain the 1.67 ratio with $618 in collateral, the TLF would have to be paid down from $430 million to $370 million with no penalty involved.
>
> **By over-collateralizing the TLF to such an extent, which would be the result if all five of the states (Colorado, Iowa, Minnesota, Missouri, and Kansas) approved the Company's request, the Company cannot pay down the TLF without penalty. If, on the other hand, the collateral and the TLF were properly aligned, based on the ratio of 1.67 to 1, portions of the asset sale proceeds would <u>have</u> to be used to pay down the TLF.**
>
> The bottom line is that the over-collateralization of the TLF does not allow the Company to refinance where it is most efficient. [Emphasis added]

Q. HOW WILL COLLATERALIZATION OF MISSOURI'S REGULATED UTILITY ASSETS HARM MISSOURI'S RATEPAYERS?

A. Missouri's regulated utility assets will be pledged as collateral against a loan that is being used by the Company to support *unregulated* operations.

Aquila is already over-collateralized for the $250 million portion of the TLF that it claims will be used for to support regulated operations. **The Company simply does not need Missouri's assets thrown into the pool.** If Aquila is allowed to collateralize Missouri's regulated assets, which will further over-collateralize the TLF, and if the Company sells unregulated assets as it has said it plans to do, the end result will be that the entire TLF will be collateralized with regulated assets. This will be true even though the Company has said that only $250 million of the $430 million TLF will support regulated operations.

Q. COULD YOU GIVE AN EXAMPLE THAT ILLUSTRATES THIS DETRIMENT?

A. Yes. Remember that Aquila has claimed that of the total $430 million TLF, $250 will be used to support regulated assets and $180 will be used to support unregulated assets. Therefore, that debt should be collateralized with like-kind assets, i.e. regulated assets collateralizing the regulated portion of the debt and unregulated assets collateralizing the unregulated portion of the debt. (It is important to remember here that from the perspective of the bank, there are NOT two portions of the TLF; that distinction exists only internal to Aquila).

1. Assume that Aquila has acquired over-collateralization of the entire $430 million TLF. The Company has obtained $800 million worth of regulated collateral and $360 million worth of unregulated collateral.

2. Assume Aquila sells an unregulated asset that reduces the unregulated collateral by $100 million to $260 million.

Based on the representations made by the Company, $180 million of the TLF is used to support unregulated operations, and the Company just sold an unregulated asset. Therefore, it would be prudent to pay off some of the debt acquired to support *unregulated* assets. However, because the TLF is over-collateralized, and because the assumed $800 million in regulated collateral is sufficient to collateralize the *entire $430 million TLF*, Aquila cannot pay off any portion of the TLF without also having to pay a penalty, the Make Whole Premium. If the Company chooses to forego that penalty, in other words, NOT pay off part of the TLF, then the end result is that a larger portion of the TLF is now collateralized with regulated assets. Assuming the Company divests all of its unregulated assets, eventually the TLF will be collateralized ONLY with regulated assets.

Q. WHAT IS THE PENALTY AQUILA WILL HAVE TO PAY IF IT PAYS OFF PART OF THE TERM LOAN FACILITY WHILE THE LOAN IS OVER-COLLATERALIZED?

A. The penalty is referred to in the loan document as the Make Whole Premium. Quite simply, the bank will be "made whole" should the Company pay off part of the TLF. Aquila is required to pay the bank, in present value dollars, the value of all future interest and principal payments. In short, the bank has protected its investment by ensuring that it WILL get the full value of the loan and all interest payments required of Aquila. The bank will either receive those payments over the course of the loan, should the TLF remain fully intact, or the bank will receive the full value **today** in present value dollars of all future payments.

If the Term Loan Facility is over-collateralized, Aquila will be unable to reduce the TLF even upon the sale of unregulated assets without paying the bank the full value of the investment.

Q. HAS AQUILA ADMITTED THAT IT PLANS TO EVENTUALLY HAVE THE TLF COLLATERALIZED SOLELY WITH REGULATED ASSETS?

A. Yes. Aquila replied to the Additional Comments of the Minnesota Department of Commerce, Docket NO. G007,011/S-03-681. In its reply, Aquila states:

> The Department's recommendation is premised on the **mistaken belief** that it would be in the best interests 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 Facility as quickly as possible. (page 1)
>
> Therefore, it is preferable for Aquila to use the proceeds from the sale of its nonregulated assts to repay those bonds **rather than repay the Term Loan** which does not mature until April, 2006. (page 4) [Emphasis added]

Stunningly, these statements are in direct contradiction to assurances Aquila made in its previously filed Reply Comments before the Minnesota Department of Commerce. In fact, in the very same document quoted above (the second Reply Comments), in which Aquila argues that it should NOT pay down the TLF even if unregulated assets are sold, it quotes its own contradictory statements from the previous set of comments:

> The amount of the Term Loan Facility secured for utility operations will not exceed $250 (unless a subsequent Aquila request is approved by the Commission authorizing an increase in utility working capital (e.g. because gas costs have increased).[sic] 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 non-utility debt will be reduced as necessary to meet this commitment.

Q. DO THESE TWO CONTRADICTORY POSITIONS MAKE ANY SENSE?

A. No. Currently, the representations, assurances, claims and commitments made by Aquila are so contradictory and convoluted as to be meaningless. What the Company has said or promised it will do, claims it will not do, and pleads it cannot do, are not only contradictory from jurisdiction to jurisdiction, and document to document within the same jurisdiction, but even within single documents.

Q. CAN YOU SUMMARIZE YOUR TESTIMONY?

A. Yes. 1. Aquila, Inc. is in its current weakened financial condition due entirely to its unregulated operations.

2. Aquila's weakened financial condition has already proved detrimental to Missouri's regulated-utility ratepayers.

3. Aquila does not need to collateralize Missouri-jurisdictional regulated utility assets in order to be in compliance with the terms of the Company's $430 Term Loan Facility.

4. Collateralizing Missouri's regulated utility assets into the pool for the $430 TLF will provide additional detriments to Missouri's ratepayers.

5. Aquila has provided disconnected, illogical and contradictory statements and representations concerning its use of the TLF and its plan to collateralize that loan, before

the Missouri Public Service Commission as well as before other regulatory jurisdictions. Simply, the Company argues the "point of the moment" without regard to what it said previously or what it will say next.

The MPSC should deny Aquila's request to encumber Missouri regulated utility assets.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

MINNESOTA
DEPARTMENT OF
COMMERCE

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June 30, 2003

PUBLIC DOCUMENT
TRADE SECRET DATA HAS BEEN EXCISED

Burl W. Haar
Executive Secretary
Minnesota Public Utilities Commission
350 Metro Square Building
121 7th Place East
St. Paul, Minnesota 55101-2147

RE: **Comments of the Minnesota Department of Commerce**
Docket No. G007,011/S-03-681

Dear Dr. Haar:

Attached are the comments of the Minnesota Department of Commerce (Department) in the following matter:

> A petition submitted by Aquila, Inc. pursuant to Minnesota Statute 216B.49, subdivision 3, requesting Minnesota Public Utilities Commission (Commission) approval to encumber Aquila Networks-Peoples and Aquila Networks-NMU Minnesota utility property to secure the payment of a $430 million loan (together with the First Mortgage Bonds, the Term Loan Facility) and to secure the future replacement debt offerings for working capital requirements not to exceed $430 million.

The petition was filed on April 30, 2003 by:

> Jon R. Empson
> Senior Vice President
> Aquila, Inc.
> 1815 Capitol Avenue
> Omaha, Nebraska 68102

The Department herein responds to the Aquila, Inc.'s (Aquila, or the Company) initial petition and subsequent written and oral responses to Department Information Requests. The Department recognizes that the Company filed "Supplemental Direct Testimony" on June 18, 2003, however, the Department has not had sufficient time to fully review this additional information prior to submitting its comments. The Department expects that Aquila can include this information in its Reply Comments and the Department can then address this discussion if so requested to by the Commission.

As to the current comments, the Department recommends that the Minnesota Public Utilities Commission **deny** Aquila, Inc.'s request to encumber Minnesota regulated property. The Department is available to answer any questions the Commission may have

Sincerely,

MARCUS D. GROSS
Rates Analyst

MDG/ja
Attachment

PUBLIC DOCUMENT - TRADE SECRET DATA HAS BEEN EXCISED

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

COMMENTS OF THE MINNESOTA DEPARTMENT OF COMMERCE

DOCKET NO. G007,011/S-03-681

I. SUMMARY OF AQUILA, INC.'S REQUEST

Pursuant to Minnesota Statute (Minn. Stat.) 216B.49, subdivision (subd. 3) and Minnesota Rules (Minn. R.), 7825.1200, 7825.1400, and 7825.1500, Aquila, Inc. (Aquila, or the Company) requests Minnesota Public Utilities Commission (Commission) approval to encumber Aquila Networks-Peoples and Aquila Networks-NMU Minnesota utility property to secure the payment of a $430 million loan (together with the First Mortgage Bonds, the Term Loan Facility) (Term Loan Facility) and to secure the future replacement debt offerings for working capital requirements not to exceed $430 million.[1]

On April 9, 2003, Aquila entered into the $430 million three-year Term Loan Facility and a 364 day $100 million loan that replaced an amount outstanding under the Company's prior revolving credit facilities and retired other maturing debt obligations.[2] In connection with the Term Loan Facility, Aquila has issued First Mortgage Bonds under its Indenture of Mortgage and Deed of Trust, dated as of April 1, 2003, to Bank One Trust Company, N.A., Trustee (the Indenture) and its First Supplemental Indenture thereto dated April 9, 2003, to Bank One Trust Company, N.A. Trustee (the First Supplemental Indenture). The Indenture, as amended and supplemented by the First Supplemental Indenture, constitutes a first mortgage lien on the property of Aquila. Currently, Aquila's regulated utility assets located in Michigan and Nebraska are subject to the lien of the Indenture.[3]

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[1] Subd. 3. **Commission approval required.** It shall be unlawful for any public utility organized under the laws of this state to offer or sell any security or, if organized under the laws of any other 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 shall first be approved by the commission. Approval by the commission shall be by formal written order.

[2] The $100 million loan can be increased to $200 million under certain circumstances, but would continue to be secured exclusively by non-domestic utility property.

[3] Michigan and Nebraska do not have state laws that require Commission approval for encumbrance of regulated assets.

According to Aquila, this Term Loan Facility is needed due to the Company's particular financial difficulties and the financial difficulties and requirements of the energy sector at large. Prior to the difficulties experienced by companies in the energy sector, Aquila was a diversified utility. The Company owned:

- Domestic and international utility networks;
- Merchant services (including wholesale energy and risk management services);
- Other energy industry investments (including electric generation, gas storage and gathering facilities); and
- Telecommunication operations.

The Company states that as a result of Enron Corporation's perfidy and the uncertainty resulting from the California energy crisis, creditors began to have concerns about the financial conditions of merchant energy companies. Thus, Moody's Investors Service (Moody's) and Standard and Poor's Corporation (S&P) developed more stringent credit guidelines for marketing and trading companies.[4] Specifically, Moody's and S&P were looking for merchant companies to have operating cash flow and/or access to additional liquidity substantially beyond traditional levels.

These guidelines raised the requirements for liquidity and balance sheet strength for merchant companies that Aquila could not meet nor sustain on an ongoing basis. Consequently, on August 2, 2002, the Company made the decision to voluntarily exit the merchant business. This decision left the Company with many stranded assets, which contain significant residual risk. Also, as Aquila attempted to shore up its balance sheet in the face of the energy-wide credit crunch, the Company was forced to sell many assets into a "buyer's" market, which resulted in sizeable book losses.

According to the Company, the deteriorating market conditions forced Aquila to violate certain interest coverage ratio covenants in the bank credit revolver. In the process of negotiating a new credit revolver and gaining a waiver of the covenant violation for the banks, Aquila had to agree to several conditions, including a commitment to make a reasonable effort to gain state regulatory approval to secure a new credit revolver with utility assets. This instant petition constitutes the Company's efforts to secure the Commission's approval to encumber Minnesota regulated assets.

II. DEPARTMENT'S ANALYSIS

The Department's analysis of this filing contains three Sections:

- financial review of Aquila;
- discussion of the Term Loan Facility and its purpose; and

[4] Aquila Merchant Services became one of the largest providers of wholesale energy and risk management services in North America. Aquila ceased merchant operations after August 2, 2002.

- effects of encumbrance.

Two main principles guide the Department's analysis:

1) A clear accounting separation must exist between any Minnesota utility's regulated and nonregulated activities. Regulated ratepayers are only responsible for paying the costs associated with providing regulated utility service to these customers. Requiring regulated ratepayers to assume responsibility for debts that were incurred to support nonregulated businesses violates the separation principle.

2) The encumbrance of Aquila's regulated assets in Minnesota must be in the interest of Aquila's Minnesota ratepayers.

Aquila has stated that encumbrance of regulated assets will produce two positive benefits for the Company. First, the Company will receive a 75 basis point reduction in the interest rate of the Term Loan Facility. Second, Aquila will use the funds above and beyond those required for domestic utility working capital needs to buy back more expensive outstanding debt. However, the Company failed to show how Minnesota ratepayers would profit from these two benefits specifically, and benefit from the encumbrance of Aquila's Minnesota assets in general.

Aquila's financial difficulties have been caused by its nonregulated operations. As DOC Attachment 1 shows, Aquila's regulated operations have been the only solid money making business for Aquila. "Telecommunications" and "Merchant Services," two lines of business in which Aquila became involved in since the late 1990's, have cost Aquila millions of dollars.

Any discussion of Aquila's request must begin with an analysis of Aquila's current financial position. The Department provides such an analysis below.

A. *REVIEW OF AQUILA'S FINANCIAL STANDING*

On January 15, 2003, the Aquila Financial Inquiry docket (Initial Comments) (Docket No. G007,011/CI-02-1369) was heard by the Commission. At that meeting, Mr. Randal Miller (Aquila Vice President Finance and Treasurer) explained the Company's plan for regaining its investment grade bond rating and its overall long-term financial viability. This section provides an overview of how the Company's financial situation has changed since that meeting.

1. *Change in Financial Condition of Aquila*

One measure of a company's financial soundness is rating agencies' bond "ratings" for that particular company. These ratings reflect the relative risk of investing in a certain company. In its Initial Comments in Aquila's financial review, the Department included Aquila's Senior Unsecured bond rating. At that time the Company's ratings were:

Moody's:	Ba2
Fitch Ratings (Fitch):	BBB-
S&P:	BBB-

Only Moody's rating was non-investment grade at that time. Both Fitch and S&P were one step above non-investment grade.

As of May 30, 2003, Aquila's current Senior Unsecured bond ratings are:

Moody's:	Caa1
Fitch:	B-
S&P:	B

All three of the bond ratings fell below investment grade. In fact, all three of the ratings are several steps below investment grade.

In assigning a rating to Aquila's new $430 million three-year secure credit facility Moody's stated recently:

> Aquila's ratings reflect (1) weak cash flow generation relative to total debt despite recent asset divestitures; (2) asset sales proceeds which do not reduce debt incurred to purchase the same assets; (3) liquidity concerns related to unwinding its trading business; and (4) the quality of the collateral as mostly stock in subsidiaries. The ratings reflect Moody's concern that asset sales do not allow sufficient cash flow to repay parent debt to a level consistent with the expected cash generation of the remaining businesses.

The non-investment grade of Aquila's debt and the discussion by Moody's indicate that Aquila may not be able to repay its debt obligations in a timely manner.

Another measure of financial soundness is the S&P Long Term Issuer Credit Rating Ratios. Standard and Poor's Compustat service provides these ratios. The Department included the fiscal year 2001 (FY01) information in its Initial Comments in Docket No. G007,011/CI-02-1369 as DOC Attachment 4. The same information for fiscal year 2002 (FY02) is included in these Comments as DOC Attachment 2. Of special interest are the "Pretax Interest Coverage" and "Cash Flow Interest Coverage" measures. As can be seen in DOC Attachment 2, both of these measures for FY02 are negative. These ratios indicate that Aquila does not have the income before taxes or the cash flow to cover its interest payments. Also, as can be seen in DOC Attachment 2, both of these measures for Aquila are comparable to measures for other utility companies that are in default.

Also, as shown in DOC Attachment 3, the S&P sample Credit Scores show that Aquila's financial position has deteriorated when compared to the Company's financial position in FY01. As can be seen, all the Aquila "Implied Scores" are "BB" or are "Below B."[5] These ~~ratings~~ imply current financial adversity and a relative vulnerability to default.

2. *Asset Sales*

The most significant change since the Commission meeting of January 15, 2003, in which Aquila's financial standing was discussed before the Commission, has been Aquila's continued divestment of non-core assets. The following have been major divestments since January:

- On April 22, 2003, Aquila announced that it would sell all of its Australian interests for approximately US$589 million, which after fees, expenses, and taxes is projected to yield net cash proceeds of US$445 million at closing.[6]

- On May 13, 2003, Aquila announced that it had terminated its 20-year tolling commitment with Acadia Power Partners LLC for $105.5 million. Aquila paid Acadia $105.5 million to release Aquila from all of its obligations under the toll. The transaction returned to Aquila $45 million in posted collateral and eliminates $843 million in payments due to Acadia over the remainder of the 20-year term. Aquila entered into the contract with Acadia in 2000.[7],[8]

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[5] According to Standard & Poor's Compustat Data Guide, "B indicates a greater vulnerability to default but currently have the capacity to meet interest payments and principal payments. Adverse business, financial, or economic conditions will likely impair capacity or willingness to pay interest principal. S&P also assigns the B rating to debt subordinated to senior debt that is assigned an actual or implied BB or BB- rating.

[6] These interests include:

- United Energy, managed and 34%-owned by Aquila, is an electric distribution utility in Melbourne, Victoria. United Energy also manages the gas distribution of Multinet Gas, in which Aquila has a 25.5% interest. United Energy and Multinet Gas distribute energy to 578,000 electric customers and 630,000 natural gas customers in areas of metropolitan Melbourne.

- Uecomm, 66%-owned by United Energy, owns fiber-optic communications networks. Uecomm serves corporate, government, and wholesale customers in five major Australian cities.

- Alinta Gas, 45%-owned by Aquila and United Energy jointly, is the major supplier and distributor of natural gas in the state of Western Australia. AlintaGas has 463,000 gas distribution customers in Western Australia, including the city of Perth.

[7] Under the toll, Aquila supplied the natural gas to a combined cycle power plant in Eunice, Louisiana, and paid fixed capacity payments for the right to sell into the wholesale market 580 megawatts of power generated by the plant.

[8] Aquila accessed the additional $100 million available under the 364-day bridge facility for the funds to buyout this contract with Acadia.

- On May 22, 2003, Aquila and FirstEnergy announced plans to sell their Aquila Sterling Ltd. Joint venture to Scottish and Southern Energy for $70 million. Aquila owns ~~79.9~~ percent of this joint venture and will share in the proceeds with FirstEnergy. Aquila's share is expected to net the Company about $14 million.[9]

These non-core asset sales will free up needed liquidity and resources for regulated assets, but the Company continues to have to take book losses on the sales, as assets are sold for less than the original purchase price. As Moody's states above these non-core asset sales are, "asset sales proceeds which do not reduce debt incurred to purchase the same assets."

3. Summary

The Department's analysis concludes that based on Aquila's current financial circumstances, as discussed above, the Company has not shown it is likely to generate sufficient cash flow to meet its future debt payment requirements.

B. OVERVIEW OF TERM LOAN FACILITY

1. Loan Facility

As discussed above, the combination of Aquila's August 2002 decision to exit the merchant business and the rapid divestiture of non-core assets that resulted in net book losses, caused the Company to breach several loan agreement covenants for maintaining specified interest coverage ratios. In order to avoid a mandatory repayment of the loans, Aquila received waivers of these breached covenants from a series of banks. The waivers and bank revolvers expired on April 12, 2003. Aquila's total debt due on April 12, 2003, was approximately **[TRADE SECRET DATA HAS BEEN EXCISED]**.[10]

In order to refinance these outstanding obligations, Aquila entered into a new $430 million, three-year secured credit facility, comprising a term loan facility and a pre-funded letter of credit facility.[11] Aquila also entered into a $200 million, 364-day bridge facility, comprising up to $100 million payable at closing and an option to draw an additional amount of up to $100 million.[12]

[9] Aquila Sterling is the owner of Midlands Electricity, the fourth biggest electric utility in the United Kingdom. Midlands Electricity serves 2.4 million network customers and also owns interests in 884 megawatts of generating capacity in the United Kingdom, Turkey, and Pakistan.

[10] On that date, Aquila had **[TRADE SECRET DATA HAS BEEN EXCISED]**.

[11] The three-year Term Loan Facility is secured by a pledge of certain utility network assets in Nebraska and Michigan, the stock of the holding company for the Canadian utility operations, and a junior lien on certain of the Company's independent power projects (IPPs).

[12] The bridge facility was borrowed by UtiliCorp Australia, Inc., a wholly-owned subsidiary of Aquila, and is non-recourse to Aquila. The bridge facility will not be supported by an Aquila parent guarantee.

stock of the holding company of Aquila's Canadian utilities and sell those properties. The Company expects to generate [TRADE SECRET DATA HAS BEEN EXCISED] from this sale, of which [TRADE SECRET HAS BEEN EXCISED] would be used to pay back debt of the Canadian holding company. Additional proceeds from this sale would be used to repay outstanding Aquila debt.

Under the terms of the Term Loan Facility, once Aquila sells the Canadian assets, the $430 million Term Loan Facility would be reduced because the Michigan and Nebraska regulated assets could only support a $200 million term loan facility. Thus, Aquila wants to substitute its other regulated utility assets in Missouri, Iowa, Minnesota, Kansas, and Colorado as collateral for the Term Loan Facility and maintain the $430 million loan capacity. Aquila's plan is that if it gains the various commission approvals to pledge these regulated assets, the assets would be encumbered and pledged directly to support the $430 million Term Loan Facility.

In a conference call with Company representatives on June 5, 2003, the Department sought to clarify how the extra $180 million portion of the Term Loan Facility would be used. The Company responded that after the sale of the Canadian assets, the Company would have some IPP's and some "remaining capacity service activity" on the nonregulated side. After further discussion with the Company, the Department concluded that the $180 million portion would not be used to support these nonregulated activities but, instead, would be used to buy back more expensive outstanding debt, albeit debt largely resulting from nonregulated activity.

Once the Canadian properties are sold, Aquila wants 100 percent of the $430 million Term Loan Facility to be supported by regulated assets. In its initial filing in this matter, Aquila made the argument that it is only "fair" to have regulated assets supporting a credit facility utilized strictly for its needs.

This argument is flawed. First, regulated assets, as shown by the Company in its Study, would require, in a worst case scenario, a $250 million credit facility. The Company's request in this docket is for a $430 million credit facility, $180 million more than required for regulated assets. Second, Aquila's need for credit facilities is the result of its failed nonregulated businesses. Such debt should not be backed up by regulated assets.

Aquila's proposal belies its claimed separation of regulated and nonregulated activities. While it claims to agree regulated assets should support a credit facility for use by regulated operations and nonregulated assets should support a credit facility for use by nonregulated operations, the Company's plan ensures that no nonregulated assets will be left among Aquila's business interests. Thus, no nonregulated assets would be available to support the extra $180 million portion of the Term Loan Facility. Aquila has made it known that if the various state commissions do not approve the encumbrance requests then the dollar amount of the Term Loan

Facility would have to be "waterfalled" down to an amount less than $430 million. To the Department, this is what should happen, as it is unreasonable for regulated assets to be used to support a credit facility for ~~use by~~ nonregulated operations.

Moreover, the Company is seeking to encumber regulated assets in order to use a credit facility, in part, to buy back debt that was, by and large, taken on by Aquila to pay for its various nonregulated activities. Such a request conflicts with the important principle of a strict accounting separation between the regulated and nonregulated operations of a utility. The idea of separation "to protect ratepayers from unwarranted costs" has been acknowledged by the Commission on numerous occasions, including the Order for Aquila's Financial Inquiry docket (Docket No G007,011/CI-02-1369).

Aquila has offered no compelling reason(s) that would justify violation of the principal of separation. Therefore, the Department recommends rejection of Aquila's request for approval to encumber Minnesota regulated assets.

C. EFFECTS OF ENCUMBRANCE

This Section discusses the implications of an encumbrance on Minnesota regulated property. The implications that will be discussed would potentially come about as a result of an Aquila bankruptcy filing. In no way is the Department expecting, forecasting, or otherwise predicting that Aquila may face bankruptcy. Any discussion of the impacts of a potential bankruptcy is included as a "worst case scenario" analysis.

1. Practical Implications of Encumbrance

As defined, an encumbrance is simply a lien or claim on property. The Department's concerns focus on the implications of a lien on Minnesota regulated property. As Aquila states on page 4 of its "Petition for Approval,"

> As explained below, pledging utility assets does not increase the risk to ratepayers, as a utility's assets are always available to debtors. The act of securing debt with utility assets is primarily a tool to improve the position of lenders over general creditors. Thus, it is important to the issuers of debt, but does not increase the risk for ratepayers.

Thus, according to the Company an encumbrance does not entail any risk in and of itself; the risk is with debt. In this case, the encumbrance is concerned with the Term Loan Facility, which is just one small part of the Company's overall debt. The Company claims that this encumbrance gives the Term Loan Facility creditors first claim to Aquila's assets, in the context of a bankruptcy proceeding.

An important issue, however, is whether or not the encumbrance somehow allows the creditor to seize and dispose of Aquila's regulated assets outside the protection of a bankruptcy proceeding. In Article IX in the *Indenture of Mortgage and Deed of Trust* agreement between Aquila and Bank One Trust Company, the Trustee (Bank One) may, in the event of default "enter upon and take possession of, the Mortgaged Property." Thus, if default occurs outside the protection of a bankruptcy proceeding then Aquila's Minnesota ratepayers will be disadvantaged vis-a-vis bankruptcy. The specifics are discussed further below.

2. *Default vs. Bankruptcy*

In response to Department Information Request No. 9 (DOC Attachment 4), the Company was asked if the Trustee could take possession of the encumbered assets without a bankruptcy proceeding. The Company responded:

> Yes, the contract gives the trustee that right. Unsecured creditors have a similar right to take possession of Aquila's assets and sell them for the purpose of satisfying judgements obtained against Aquila for defaulting on its obligations to them.
>
> The practical reality is that if a secured or unsecured creditor attempted to take possession of Aquila's assets for the purpose of satisfying Aquila's defaulted obligations to that creditor, Aquila would file for bankruptcy protection. The automatic stay provision of the bankruptcy code would require the creditor to immediately halt its collection efforts. Aquila would then be permitted to retain its assets and operate its business while it developed a reorganization plan in accordance with the bankruptcy code.

The Company attempts to minimize the possible effect of default. It claims that default on the Term Loan Facility and a bankruptcy filing are the same thing. It claims that, although the Trustee could take immediate possession of Aquila's property in an event of default this really would not occur because Aquila would seek bankruptcy protection to prevent that from happening. Then the bankruptcy court would sort out the specifics of the disposition of the Company's assets.

The document's own terms speak for themselves. The Company does not have to file for bankruptcy in the event of default. It is the Trustee's right to seize the Company's assets in the "Event of Default" and Aquila does not have to file for bankruptcy protection in that situation.

Aquila's response to Information Request No. 9 supports the Company's statement from Page 4 of the Petition that the risk is not with any regulated asset encumbrance but rather with the debt of Aquila. In sum, the risk for the ratepayers does not appear to be any greater with encumbrance than without encumbrance in the event of bankruptcy.

3. *Public Interest Standard*

The litmus test for the Department's recommendation for approval of the Company's request is that the approval would be in the public interest. Based on this standard, the Department must determine if the benefits of encumbrance (the purchase of more expensive outstanding Aquila debt with the $180 million of the Term Loan Facility and the 75 basis point reduction in the interest rate on the Term Loan Facility) significantly improves the Company's financial position. To date, the Company has not provided sufficient information that would allow the Department to reasonably conclude that encumbrance is in the public interest. Thus, the Department recommends the Commission reject the Company's request for approval to encumber Minnesota regulated assets.

Further, the Department has always maintained that a clear accounting separation must exist between a utility's regulated and nonregulated operations. Aquila's current request violates that premise. Aquila has offered no compelling reason(s) that would justify violation of this separation principle. Therefore, the Department recommends rejection of Aquila's request for approval to encumber Minnesota regulated assets.

In summary, the Department cannot identify how the Company's request to encumber Minnesota regulated assets is in the public interest. The Department invites Aquila to address the Department's concerns that have been detailed herein in the Company's Reply Comments.

III. CONCLUSIONS AND RECOMMENDATIONS

Based on its analysis, the Department concludes that Aquila's request for approval to encumber Minnesota regulated assets is not consistent with the public interest. Upon review of Aquila's request to encumber Minnesota regulated property, the Department recommends that the Commission deny the Company's request for approval, absent a showing in Aquila's Replay Comments of:

- A showing that encumbrance is in the public interest; and

- a compelling reason(s) to violate the principle of keeping a clear accounting separation between a utility's regulated and nonregulated activities.

/ja

Aquila

2002 & Q1 EBIT by Business Segment

($ Millions)		Full Year 2002	Q1 2003	Q1 2002	Variance
1)	Global Networks Group:				
2)	Domestic Networks	$ 125.8	$75.0	$45.0	$ 30.0
3)	Quanta	(699.3)	(.2)	8.1	(8.3)
4)	Communications	(256.1)	(4.2)	(7.0)	2.8
5)	International Networks	(70.1)	10.6	33.6	(23.0)
6)	Total Global Networks	(899.7)	81.2	79.7	1.5
7)	Total Merchant Services	(671.0)	(101.3)	23.7	(125.0)
8)	Corporate and Other	(37.7)	(1.1)	(16.7)	15.6
9)	Total EBIT	$(1,608.4)	$(21.2)	$ 86.7	$ (107.9)
10)	Interest Expense	249.5	65.1	48.6	(16.5)
11)	Income Tax Benefit	(135.1)	(34.4)	(1.9)	32.5
12)	Earnings (Loss) from Continuing Operations	$(1,722.8)	$(51.9)	$ 40.0	$ (91.9)

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

AQUILA INC
TICKER: ILA
Latest FY: Dec02
CURRENT RATINGS AS OF 31May03
S&P LT ISSUER CREDIT RATING: B

S&P LONG-TERM ISSUER CREDIT RATING RATIOS
Industry Comparisons

GICS Group [Utilities]

Rating	# of Cos. 243	Long Term Debt % of Total Capital Min	Avg	Max	Pretax Interest Coverage x Min	Avg	Max	Cash Flow Interest Coverage x Min	Avg	Max
AAA	1	96.9	96.9	96.9	1.2	1.2	1.2	1.9	1.9	1.9
AA	6	34.8	40.6	46.8	0.5	3.5	5.8	3.5	5.1	7.8
A	88	17.2	48.2	87.0	(1.0)	3.7	9.4	0.4	4.6	11.4
BBB	103	23.6	54.0	87.4	(1.3)	2.9	8.3	0.4	3.9	9.0
Speculative	40	25.4	59.4	127.4	(7.0)	1.5	8.6	(5.5)	2.1	7.1
In Default	5	(15,950.0)	(3,144.0)	113.4	(6.3)	0.7	4.0	(4.3)	1.3	4.0
AQUILA INC			59.7			(7.0)			(5.5)	

Rating	# of Cos. 243	Cash Flow % of Long Term Debt Min	Avg	Max	Asset Turnover x Min	Avg	Max	Equity Book Value/ Book Value of Liabilities Min	Avg	Max
AAA	1	6.2	6.2	6.2	0.2	0.2	0.2	0.0	0.0	0.0
AA	6	17.0	32.9	67.0	0.4	0.5	0.7	0.3	0.5	0.7
A	88	(5.0)	27.3	80.0	0.2	0.4	0.9	0.1	0.5	1.9
BBB	103	(8.9)	22.3	67.5	0.1	0.4	1.1	0.1	0.4	0.9
Speculative	40	(62.9)	9.8	50.0	0.1	0.4	1.1	(0.1)	0.4	1.3
In Default	5	(220.4)	(17.3)	77.3	0.2	0.4	0.6	(0.1)	0.5	1.1
AQUILA INC			(62.9)			0.2			0.2	

Rating	# of Cos. 243	Return on Total Capital % Min	Avg	Max	Operating Income % of Sales Min	Avg	Max	Total Liabilities % of Tangible Net Worth Min	Avg	Max
AAA	1	1.0	1.0	1.0	40.1	40.1	40.1	4,289.8	4,289.8	4,289.8
AA	6	(1.4)	4.9	11.3	19.2	21.8	25.2	134.9	375.4	1,321.8
A	88	(9.7)	5.5	13.6	9.2	28.3	76.5	(47,823.9)	(314.6)	1,604.8
BBB	103	(14.1)	4.4	13.1	(4.9)	25.7	62.6	(10,819.6)	(14.0)	2,553.5
Speculative	40	(47.8)	(1.5)	13.4	(72.2)	23.2	87.5	(6,258.6)	133.5	1,397.5
In Default	5	(15.1)	4.9	21.8	(131.7)	8.2	77.7	(1,724.6)	(389.8)	466.9
AQUILA INC			(42.9)			(72.2)			584.8	

Schedule MB-1
Page 14 of 17

This is a *sample model* demonstrating how Compustat data through Research Insight can be applied to derive implied corporate debt scores for Credit Analysis.

This spreadsheet model calculates the eight key ratios that S&P's Ratings Group uses. The subject company's ratios are compared against the latest three-year medians found in the S&P Corporate Ratings Criteria, which are shown in the Medians worksheet of this workbook.

Based on these medians, a system of assigning detailed measures has been constructed to derive the implied debt scores.

To customize the scoring category titles (i.e., AAA, AA, A, etc.), go to the Settings sheet and change the User Defined Categories (column E). Then in the Values for each Scoring Category table, assign numerical values for each rating (column F).

To customize the Implied Overall Scoring category, go to the Settings sheet and change the Avg. Score Scale for Overall Scoring table (column K).

To customize the ratio ranges between each category, go to the Settings sheet and change the Ratio Ranges for the Scoring Categories table (using [illegible] to J19).

To run the model, invoke the Run Wizard via the S&P menu option or, if visible, the running person icon in the toolbar.

********** This model is not intended to replicate or represent the S&P Credit Ratings **********

***** The derived ratings are based purely on quantitative analysis *****

[illegible] Electric & Other Serv Comb

Ratios										
for years ended:	Dec93	Dec94	Dec95	Dec96	Dec97	Dec98	Dec99	Dec00	Dec01	Dec02
EBIT Interest Coverage (x)	1.5	2.3	2.0	1.8	1.9	1.9	1.9	1.8	2.1	8.4
EBITDA Interest Coverage (x)	2.9	3.6	3.3	2.8	3.0	3.2	3.1	3.0	3.5	9.4
Funds From Operations as % of Total debt	22.9%	22.0%	16.7%	15.2%	21.1%	18.9%	12.7%	15.7%	14.3%	14.1%
Free Operating Cash Flow as % of Total Debt	13.8%	5.5%	8.6%	7.0%	12.5%	7.9%	12.2%	15.4%	0.9%	-17.5%
Pretax Return on Permanent Capital	7.8%	10.3%	9.4%	10.4%	10.4%	11.0%	10.3%	11.2%	11.1%	-30.0%
Operating Income as % of Sales	18.3%	24.4%	13.2%	8.1%	4.2%	3.1%	2.8%	1.9%	1.7%	-71.2%
LT Debt as % of Capitalization	51.2%	50.4%	60.0%	55.9%	54.4%	48.0%	61.4%	60.6%	52.4%	59.7%
Total Debt as % of Capitalization	52.3%	57.5%	64.4%	59.9%	58.5%	55.1%	64.0%	64.8%	54.4%	66.6%

Implied Scores										
	Dec93	Dec94	Dec95	Dec96	Dec97	Dec98	Dec99	Dec00	Dec01	Dec02
EBIT Interest Coverage (x)	BB	BB	BB	BB	BB	BB	BB	BB	BB	Below B
EBITDA Interest Coverage (x)	BB	BBB	BB	BB	BB	BB	BB	BB	BB	Below B
Funds From Operations as % of Total debt	BBB	BBB	BB	BB	BBB	BB	BB	BB	BB	BB
Free Operating Cash Flow as % of Total Debt	A	BBB	BBB	BBB	BBB	BBB	BBB	A	BB	Below B
Pretax Return on Permanent Capital	BB	BB	BB	BB	BB	BBB	BB	BBB	BBB	Below B
Operating Income as % of Sales	A	AAA	BB	Below B	Below B	Below B	Below B	Below B	Below B	Below B
LT Debt as % of Capitalization	BBB	BBB	Below B	BBB	BBB	BBB	Below B	Below B	BBB	BB
Total Debt as % of Capitalization	BBB	BBB	BB	BBB	BBB	BBB	BB	BB	BBB	BB

Score Values										
	Dec93	Dec94	Dec95	Dec96	Dec97	Dec98	Dec99	Dec00	Dec01	Dec02
EBIT Interest Coverage (x)	2	2	2	2	2	2	2	2	2	0
EBITDA Interest Coverage (x)	2	3	2	2	2	2	2	2	2	0
Funds From Operations as % of Total debt	3	3	2	2	3	2	2	2	2	2
Free Operating Cash Flow as % of Total Debt	4	3	3	3	3	3	3	4	2	0
Pretax Return on Permanent Capital	2	2	2	2	2	3	2	3	3	0
Operating Income as % of Sales	4	6	2	0	0	0	0	0	0	0
LT Debt as % of Capitalization	3	3	0	3	3	3	0	0	3	2
Total Debt as % of Capitalization	3	3	2	3	3	3	2	2	3	2
Average Score	2.875	3.125	1.875	2.125	2.25	2.25	1.625	1.875	2.125	0.75
Implied Overall Score	BBB	BBB	BB	BB	BB	BB	BB	BB	BB	B

AQUILA, INC.
DOCKET NO. G007,011/S-03-681
DATA REQUEST NO. DOC-9

DATE OF REQUEST: May 28, 2003

DATE RECEIVED: May 28, 2003

~~**DATE DUE:** June 9, 2003~~

REQUESTOR: Marcus Gross

QUESTION 9:

Subject: Event of Default; Remedies
Reference: "Indenture of Mortgage and Deed of Trust" Contract Article IX, page 71.

In the case of default, under the terms of Article IX *Events of Default; Remedies*, can the Trustee (Bank One Trust Company, N.A.) take possession of the encumbered assets without a bankruptcy proceeding? Please provide a detailed answer.

RESPONSE: Yes, the contract gives the trustee that right. Unsecured creditors have a similar right to take possession of Aquila's assets and sell them for the purpose of satisfying judgments obtained against Aquila for defaulting on its obligations to them.

The practical reality is that if a secured or unsecured creditor attempted to take possession of Aquila's assets for the purpose of satisfying Aquila's defaulted obligations to that creditor, Aquila would file for bankruptcy protection. The automatic stay provision of the bankruptcy code would require the creditor to immediately halt its collection efforts. Aquila would then be permitted to retain its assets and operate its business while it developed a reorganization plan in accordance with the bankruptcy code.

ATTACHMENT: NA

ANSWERED BY: Chris Reitz

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 will not be used to support a credit facility for use by nonregulated operations. Aquila agrees not 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 do not 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 ________________________________
Michael J. Bradley

MOSS & BARNETT
A Professional Association
4800 Wells Fargo Center
90 South Seventh Street
Minneapolis, MN 55402-4129
Telephone: 612-347-0337

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

MINNESOTA
DEPARTMENT OF
COMMERCE

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AUG 2 0 2003

MICHAEL J. BRADLEY

August 19, 2003

Burl W. Haar
Executive Secretary
Minnesota Public Utilities Commission
121 7th Place East, Suite 350
St. Paul, Minnesota 55101-2147

RE: *Additional Comments* of the Minnesota Department of Commerce
Docket No. G007,011/S-03-681

Dear Dr. Haar:

On April 30, 2003, Aquila, Inc. (Aquila, or the Company) filed its initial request (Initial Request) for,

> approval to encumber Aquila Networks-Peoples and Aquila Networks-NMU Minnesota utility property to secure the payment of a $430 million loan[.]

On June 30, 2003, the Minnesota Department of Commerce (Department) issued its *Initial Comments* (*Comments*) in this matter. On July 15, 2003, Aquila issued its *Reply Comments* (*Reply Comments*) On July 21, 2003, the Minnesota Public Utilities Commission (Commission) issued a formal notice of a fifteen-day *Additional Comment* period. The *Additional Comment* period was extended to August 19, 2003. These comments constitute the Department's *Additional Comments* pursuant to the Commission's notice.

The Department has had a face-to-face meeting with the Company and several phone conversations in order to fully understand Aquila's position. However, these discussions have led the Department to conclude approval of the Company's request would not be in the public interest. Therefore, the Department recommends that the Commission deny the Company's request to encumber Minnesota assets. The Department does appreciate the Company's willingness to meet with the Department and discuss the details of this matter.

The Company's original intent with regards to the Term Loan Facility (TLF) has changed since the Company's April 30, 2003, Initial Request. Aquila's original intent for the TLF, as discussed by the Department on page 8 of its *Comments*, would be to use $180 million of the $430 million TLF to buy back the Company's more expensive outstanding debt The Department protested this use of the TLF as a violation of the separation principle. However, per the Company's *Reply Comments* this would no longer be the case. According to the Company on page 3 of its *Reply Comments*,

> Aquila agrees not 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. (Emphasis in original.)

On Wednesday, July 30, 2003, the Department and Aquila met to discuss the finer points of the Company's proposal and to see if a potential agreement could be reached. The Department wanted to ensure that regulated assets were not being used to secure a larger credit facility than was needed to support domestic utility working capital needs. Thus, Aquila verbally agreed at the meeting that upon selling collateralized nonregulated assets, it would "pay down" the current $430 million TLF to $250 million. This would properly align the amount of credit required by Aquila's regulated domestic utilities and the size of the credit line that should properly be secured by regulated assets. This would preserve the separation principal discussed by the Department in its June 30, 2003 *Comments*.

However, after the meeting, Aquila changed its response to the Department's offer by concluding that if it would buy down the TLF other than as required by the terms of the TLF, there would be a significant pre-payment penalty, the "Make Whole Premium."[1]

A review of the appropriate section of the TLF convenants (Section 2.7(a)(1)) did not fully answer the Department's questions, so on August 4, 2003, the Department contacted Chris Reitz of Aquila for further clarification. This discussion revolved around the distinction of the definition of "pre-payment." It was learned that there are two different pre-payments, an "Optional" and "Mandatory" pre-payment. The Make Whole Premium is required only when Aquila makes an "Optional" pre-payment.

The definition of these two different pre-payments is based on the level of collateralization of the $430 TLF. The following two examples should explain the distinction between "Optional" and "Mandatory" pre-payments.

> Optional Pre-payment: The Company is required to maintain a collateral-to-debt ratio of 1.67 to 1; this is important to keep in mind. Thus, the minimum amount of collateral that is required for the $430 million TLF is $718 million. So, for example, if Aquila had $900 million in assets securing the TLF, the Company could sell $100 million of the $900 million in collateral and not be obliged to pay down the $430 million TLF. The ratio of collateral would be $800 million to $430 million, or 1.86 to 1, still in excess of the minimum ratio of 1.67 to 1. Therefore, Aquila could use the $100 million to repurchase more expensive outstanding debt or whatever uses it had for this money. However, if Aquila decided to use the proceeds to pay back part of the $430 million debt, it would have to pay a significant pre-payment (a.k.a. "Make Whole Premium) penalty.
>
> Mandatory Pre-payment: If, on the other hand, Aquila only had the minimum amount of collateral required for the TLF, $718 million, then any proceeds from the sale of assets would have to be used to pay down, without penalty, the $430 million TLF and maintain the 1.67 to 1 ratio. So, for example, if Aquila had $718 million in collateral for the TLF and then sold $100 million in assets, the collateral ratio would be $618 million to $430 million, or a ratio of 1.44 to 1. Thus, the bank would not allow Aquila to maintain the $430 million TLF because it would not be

[1] The "Make Whole Premium" basically refers to the loan conditions agreed to by the parties that govern the changes in the original payment schedule and terms

properly collateralized, according to the terms of the loan agreement. So for Aquila to maintain the 1.67 ratio with $618 million in collateral, the TLF would have to be paid down from $430 million to $370 million with no penalty involved.

By over-collateralizing the TLF to such an extent, which would be the result if all five of the states (Colorado, Iowa, Minnesota, Missouri, and Kansas) approved the Company's request, the Company cannot pay down the TLF without penalty. If, on the other hand, the collateral and the TLF were properly aligned, based on the ratio of 1.67 to 1, portions of the asset sale proceeds would have to be used to pay down the TLF.

The bottom line is that the over-collateralization of the TLF does not allow the Company to refinance where it is most efficient. The $430 TLF has an interest rate of 8.75 percent (lowered to 8.00 percent when the 1.67 ratio of collateral to the amount of the TFL outstanding), which is expensive in today's environment. But if the loan is over-collateralized, Aquila cannot pay down the TLF without penalty. Thus, the Company would have an incentive to buy back other outstanding debt, but debt that is lower cost than the cost of the current $430 TLF.

Ideally, without the "Make Whole Premium" the Company would pay down the relatively expensive TLF, but because of the onerous loan covenants, the Company cannot do this. Thus, the Department concludes that it is counter to the needs of Minnesota ratepayers and even to the Company itself, to allow Aquila to encumber Minnesota regulated property. By properly aligning the collateral pool with the size of the TLF, the Company can more efficiently refinance its outstanding debt and thus benefit its ratepayers and shareholders.

The Department concludes that it would not be in the public interest if the Commission approved the Company's request. Therefore, the Department recommends that the Commission deny Aquila's request to encumber Minnesota regulated assets. The Department is available for any questions that the Commission may have on this matter.

Sincerely,

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(651) 296-0404

VCC/MDG/ja

STATE OF MINNESOTA)
) ss
COUNTY OF RAMSEY)

AFFIDAVIT OF SERVICE

I, **Linda Chavez**, on the **19th** day of **August, 2003**, served the attached **Minnesota Department of Commerce – Additional Comments**

Docket Number(s): **G007,011/S-03-681**

X by depositing in the United States Mail at the City of St. Paul, a true and correct copy thereof, properly enveloped with postage prepaid.

X by personal service

by express mai

by delivery service

to all persons at the addresses indicated below or on the attached list:

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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 **<u>any public utility</u>** organized under the laws of this state **<u>to sell any security</u>** 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 **<u>unless the security issuance of the public utility</u>** 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 **<u>any debt</u>** 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 ______________________________
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POWER POINTS: Back-To-Basics May Not Pay Aquila's Bills

By MARK GOLDEN

A Dow Jones Newswires Column

NEW YORK -- Maybe one reason you can't go back to the farm after having been to Paris is that you can't pay off your Chanel and Gaultier bills on a farmer's income.

That may be the lesson learned by Aquila Inc. (ILA), which is trying to return to its roots as a basic power and natural gas regulated utility in the Midwest.

The income from that line of business may not cover the cost of servicing leftover debt from almost $2 billion in poor investments in telecom, merchant energy and a British utility. Regulators aren't going to let customers of Aquila's monopoly gas business back in Missouri, for example, pay for the company's unused merchant power plants.

So the company's future depends on its ability to sell assets at good prices to pay off debt and reduce interest costs as much as possible. Some analysts don't think it will work.

"I don't see them digging out of the hole," said Bank of America Securities' debt analyst Craig Gilbert. "In our view they aren't going to generate enough free cash flow in the future to materially reduce debt, but the value of the assets should come close to the liabilities."

Aquila executives admit that the road ahead is rough.

"At this point, with our stock in the $2 range, we're like an option premium on how the divestitures come out," Aquila Chief Financial Officer Rick Dobson said in an interview.

Even after the company finishes selling noncore assets and negotiating discounts on some obligations, it still will have some debt left over from its failed investments.

"That leaves an overhang on our books," said Dobson. "Whether that's $100 million or $500 million, almost all debt holders are doing the math, and coming to their own conclusions."

Tough Numbers

For investors, the math isn't that complicated. Once the company sheds assets and gets through numerous requests for gas and electric rate increases, it projects a slightly optimistic earnings before interest and taxes from its utilities of about $250 million a year, up from about $180 million from its utilities currently.

Taxes will likely be negligible, but its current annual interest expense is about $260 million. State utility regulators won't force trapped power and gas customers to pay for the higher interest rates that resulted from credit downgrades due to its nonutility ventures.

For debt allocated among Aquila's various local utilities, customers reimburse Aquila at interest rates of 7% to 8%, as if the company were still investment grade. In fact, Standard & Poors rates it single-B, five steps below investment grade. The highest interest rate it pays - on a recent $500-million bond issue - is a whopping 14 7/8%.

Aside from interest expense, Aquila for years to come has to spend more than $130 million annually buying natural gas for other utilities that have already paid Aquila. The company is also paying $37 million a year through 2015 for the right to generate power at a big merchant power plant in Illinois that can't make money in the current market. A similar long-term deal will start costing $21 million in 2006.

If interest costs aren't reduced, that would add up to a cash burn rate of almost $200 million a year, so the key is to sell assets and pay off debt. Big bondholders - conservative types by definition - usually discount management's utility earnings projections and start with higher current interest expense.

Clarity To Come

The critical element in Aquila's cash picture is what prices it gets for its Canadian utilities and its profitable independent power plants, known as "qualifying facilities," which have contracts to sell power to other U.S. utilities. The company has received indicative bids, but it won't share numbers until it has agreements in hand later this year.

"By the time we report third-quarter earnings, a lot of the mystery should be solved," said Dobson, who added that Aquila's big rate cases won't be resolved until next spring.

Gilbert estimated that after fees and taxes Aquila may get about $600 million for its Canadian utilities and $200 million to $250 million for its qualifying facilities. Gilbert, who also trades Aquila debt, thinks those sales will keep Aquila going for a couple of years, so he has a "buy" rating on the company's near-term debt. But he doesn't see how the company can become cash-flow positive any time soon.

Most Wall Street estimates on what Aquila will get for the assets, Dobson said, are at the low end of the company's expectations. In any event, Aquila can't use all of the proceeds to pay down debt, he said. It needs to retain some cash to get through the current negative cash flow period, though it will certainly pay off $400 million in bonds due next year.

As of June 30, the company had a little more than $500 million cash on hand. For the first half of the year, its continuing operations lost $159 million.

What Isn't For Sale

The company has already sold its Australian utility, and the potential sale of its British utility is basically a wash from a debt perspective.

Aquila's three new merchant power plants in Illinois and Mississippi aren't for sale, because they wouldn't fetch much in those oversupplied markets; they aren't even running in the summer.

On the plus side, as the company winds down its trading operation, it will get back collateral it has deposited with counterparties.

Aquila is also negotiating to reduce its obligations on the prepaid gas supplies and its purchased-capacity contracts. Moreover, Aquila is asking several state utility commissions to allow it to pledge utility assets as collateral to contain interest rates.

One other potential help: If U.S. wholesale electricity prices rebound in a couple of years, Aquila's remaining merchant generating stations in Illinois and Mississippi could finally start generating income.

The company's own estimate, however, is that the plants won't start earning meaningful income until 2006 at the earliest.

At the end of the day, said Ellen Lapson, debt analyst with Fitch Ratings, Aquila may be a highly leveraged business relative to its utility income.

"That doesn't mean that it's out of business," Lapson said. "There have been examples, like Tucson Electric Power and El Paso Electric, of highly leveraged utilities that have managed it very gradually over time."

If the company can't pay off extraneous debt from its utility profits, its board of directors could issue new stock or pursue a merger with a bigger company, Dobson said. At the current price, any new stock issue would have to be quite large to make a difference, he added.

Bank of America's Gilbert has a "neutral" rating on Aquila's debt that matures after 2006.

"I see them hanging around for a while," he said, "but eventually they may need to restructure."

-By Mark Golden, Dow Jones Newswires; 201-938-4604; mark.golden@dowjones.com

(Mark Golden has reported on electricity markets and policy for six years.)

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