BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of the Application of Aquila, Inc. for Authority to Assign, Transfer, Mortgage or Encumber its Utility Franchise, Works or System in Order to Secure Revised Bank Financing Arrangements	))))))	Case No. EF-2003-0465

INITIAL POST-HEARING BRIEF OF AQUILA, INC.

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***** DENOTES HIGHLY CONFIDENTIAL INFORMATION *****

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I. INTRODUCTION

On April 30, 2003, Aquila, Inc. ("Aquila" or "Company") filed an application (the "Application") with the Missouri Public Service Commission ("Commission") for authority under § 393.190 RSMo 2000 to subject its utility works and system located in the State of Missouri to the lien of its Indenture of Mortgage and Deed of Trust (the "Indenture") to secure $430 million of First Mortgage Bonds issued in April of 2003 pursuant to the terms of a three year Term Loan. The Term Loan was needed to ensure continued liquidity for ongoing operations, including for peak cash working capital requirements for its utility operations in Missouri as well as the states of Kansas, Nebraska, Iowa, Michigan, Minnesota and Colorado.

The background events that led up to the filing of the Application have been recounted in the testimony of Aquila witness Rick Dobson[1] and, also, in a report filed by the Commission's Staff in December of 2002 concerning the financial condition of Aquila and the implications the Company's liquidity challenges and restructuring plan had for the

[1] (Dobson, Exh. 4, p. 2-9)

Company's regulated operations in the State of Missouri (the "Report"). The Report was submitted to the Commission on December 17, 2002 and that document has been filed of record in this case as Schedule 1 to the prepared rebuttal testimony of Staff witness Joan Wandel.[2] (Exh. 13, Sch. 1; Exh. 14).

This brief will demonstrate that under the applicable legal standard governing requests under § 393.190 RSMo, the Commission should approve the Application. In summary, the Commission is required to approve Aquila's Application unless doing so would be detrimental to the public interest. The specific issue presented in this case is whether granting the relief sought by Aquila will cause a direct and present detriment to the public interest. As will be demonstrated herein, Aquila has made its *prima facia* showing that approval of the Application will not in any manner alter the *status quo* and the parties opposing the Application have not presented any evidence whatsoever that approval of the Application will cause a direct and present detriment to the public interest.

II. DISCUSSION

A. The Standard for Approval of the Application

By virtue of its October 9, 2003 Order Denying Motion for Summary Disposition, the Commission has already confirmed the appropriate standard for approval of the Application. In that order, the Commission held that the controlling standard for approval of applications filed pursuant to §393.190 RSMo is that such applications may only be disapproved if there is a showing that doing so would be detrimental to the public interest.[3]

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[2] The Report was thorough and comprehensive. Jon Empson, on behalf of Aquila, submitted a response to the Report commending Staff's review and offering a number of observations. Those comments are included in the Report at pages 60-62.

[3] Order Denying Motion for Summary Disposition, p. 3.

The seminal case is *State ex rel. City of St. Louis v. Public Service Commission*, 73 S.W. 2d 393 (Mo. banc 1934) in which the Missouri Supreme Court concluded that it was not a requirement that the Commission find that the public be benefitted by approval of the transaction but, rather, it is "their duty to see that no such change shall be made as would work to the public detriment. 'In the public interest' in such cases, can reasonably mean no more than 'not detrimental to the public.'" *Id.* at 400.[4] The Missouri Supreme Court's decision was based on the constitutionally protected right of the utility to apply the property owned by it to its best financial advantage. "To deny them that right," the Court said, "would be to deny them an incident important to ownership of property." *Id.*[5]

The Commission has previously concluded that the mere possibility of a scenario of events that may, or may not, result in future adverse consequences is not legally sufficient to make a showing that a transaction is detrimental to the public interest. To the contrary, once the applicant has made a *prima facia* showing that the *status quo* will not be disturbed, the burden of going forward with the evidence shifts to those parties claiming that the transaction is detrimental to the public interest in some fashion.[6] In this case, those parties are Staff, OPC, the State of Missouri and SIEUA/AGP. They are obliged to present "compelling evidence" of a "direct and present public detriment."[7]

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[4] Aquila incorporates herein by reference as though more fully set forth at length its Legal Memorandum of Aquila, Inc. in Support of its Response to Joint Motion for Summary Disposition and Request for Oral Argument filed with the Commission on September 22, 2003.

[5] This standard was subsequently echoed by the Eastern District Missouri Court of Appeals in *State ex rel. Fee Fee Trunk Sewer Company v. Litz*, 596 S.W. 2d 466 (Mo. App. 1980) and thereafter incorporated in the Commission's applicable filing requirements at 4 CSR 240-3.110 and 4 CSR 240-3.115.

[6] Report and Order, Case No. EM-2000-292, December 14, 2000, (Slip Op. at 32-33); *rev'd on other gnds., State ex rel. AG Processing, Inc., v. Public Service Commission*, Case No. SC85352 (Slip. Op. at pp.6-7).

[7] *See, Re Missouri-American Water Company*, 9 Mo.P.S.C. 3d 56, 59 (2000).

In separate cases, the Commission has also concluded that a detriment that is (1) short term in nature or (2) is "offset by benefits or mitigated by conditions" can be approved under the *City of St. Louis* "not detrimental" standard. *See*, *Re Union Electric Company*, 1 Mo.P.S.C. 3d 501 (1992); *Re Gateway Pipeline Company*, ___ Mo.P.S.C. 3d _____, 201 Mo.P.S.C. Lexis 1371 (2001). Given this legal threshold, the Commission has never before disapproved an application filed pursuant to §393.190.1 RSMo., to the Company's knowledge.

The threshold of approval under §393.190 RSMo is reflective of the important constitutional property right reserved to the utility to utilize its properties to its best financial advantage. There is no countervailing right reserved to the utility's customers. The Missouri Supreme Court has rejected the concept that the ratepayers have any property interest in the assets used to provide them with utility service. Quoting the United States Supreme Court in *Board of Public Utility Commissioners v. New York Telephone Company*, 271 U.S. 23, 46 S.Ct. 363, 366, the Missouri Supreme Court stated that "[c]ustomers pay for service, not for property used to render it. Their payments are not contributions to depreciation or other operating expenses or to the capital of the company. **By paying bills for service they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company.** Property paid for out of monies received for service belongs to the company just as does that purchased out of proceeds from its bonds and stock." *Id.* at 14. (Emphasis added.)

B. Need is a Matter to be Determined by the Utility's Management

Most of the evidence offered by the parties opposing the Application, submitted prior to the ruling on the Joint Motion for Summary Disposition, has focused on whether there is any need for the authority requested in the Application. As noted above, the Commission has rejected the "needs" test. Moreover, the great weight of legal authority in this state stands for the proposition that the determination of need is one reserved exclusively to the informed discretion of the company's management, and not the Commission.

The leading case on this topic is *Missouri ex rel. Southwestern Bell Telephone Company v. Public Service Commission of Missouri*, 262 U.S. 276, 43 S.Ct. 544 (1923) in which the Supreme Court stated plainly that "the Commission is not the financial manager of the corporation, and it is not empowered to substitute its judgement for that of the directors of the corporation." 43 S.Ct. at 547. The Courts of this state have echoed this important distinction between management decisions, which are reserved by law to the utility's board of directors and officers, and regulatory considerations, which are reserved to the Commission.

In *State ex rel. City of St. Louis v. Public Service Commission*, 30 S.W.2d 8 (Mo. banc 1930), the Missouri Supreme Court stated that:

> The holding company's ownership of the property includes the right to control and management it, subject, of course, to state regulation through the public service commission, **but it must be kept in mind that the Commission's authority to regulate does not include the right to dictate the manner in which the company shall conduct its business. The company has the lawful right to manage its own affairs and conduct its business in any way it may choose, provided that in doing so, it does not injuriously affect the public.** The customers of a public utility have a right to demand efficient service at a reasonable rate, but they

> have no right to dictate the methods which the utility must employ in the rendition of that service. (Emphasis added.)

Id. at 14. Later, the Kansas City Court of Appeals reaffirmed this view in *State ex rel. Harline v. Public Service Commission*, 343 S.W.2d 177 (Mo. App. 1960). In that case, the Court of Appeals said:

> the dominating purpose in the creation of the Public Service Commission was to promote the public welfare. **To that end the statutes provided regulation which seeks to correct the abuse of any property right of a public utility, not to direct its use. Exercise of the latter function would involve a property right in the utility. The law has conferred no such power upon the Commission.** (Emphasis added.)

The Court of Appeals continued its analysis by observing that the Commission's powers are "purely regulatory." *Id.* at 181. The Court elaborated on this important principle of regulation.

> The utility's ownership of its business and property includes the right to control and manage, subject, necessarily to state regulation through the Public Service Commission. The powers of regulation delegated to the Commission are comprehensive and extend to every conceivable source of corporate malfeasance. **Those powers do not, however, clothe the Commission with the general power of management incident to ownership. The utility retains the lawful right to manage its affairs and conduct its business as it may choose, as long as it performs its legal duty, complies with lawful regulation and does no harm to the public welfare.** (Emphasis added.)

C. Aquila's Management has Explained its Business Purpose and Objectives

The evidence offered by Aquila shows that its request to encumber its Missouri assets to support its obligations under the Term Loan is an important facet in the successful execution of the Company's financial plan. Its overall strategy is to exit the merchant energy business, sell non-strategic assets and businesses, here and abroad, and apply the proceeds for those sales to reduce associated liabilities and debt. (Dobson,

Exh. 4, p. 5-9; Exh. 8, p. 6, l. 7-10). This is all in furtherance of its stated goal of shoring up its balance sheet and retrenching as a multi-state US utility company and thereby achieving its objective of regaining an investment grade debt rating.

Aquila prepared an internal study of its domestic utility peak working capital needs. It utilized the budget information supporting the financial plan.[8] The key drivers were found to be natural gas purchased for distribution and fuel for power generation. That study caused the Company to conclude that it required peak liquidity capacity of at least $250 million to protect the domestic utility business, including its operations in the State of Missouri. (Dobson, Exh. 4, p. 11-10). The determination of working capital requirements for financing purposes needs to be distinguished from the working capital balance determined for ratemaking purposes. In the former circumstance, need is determined by looking at daily cash requirements to establish the amount of cash needed to meet the peak day during the year. For ratemaking purposes, on the other hand, the Commission is asked to approve an average annual working capital balance as a permanent investment by the utility. Consequently, it would not be appropriate to employ the same methodology used to determine the working capital component of rate base to also determine the peak working capital needs for financing operations. (Lowndes, Exh. 3, p. 8-9).

At the time this case went to hearing, Aquila had sufficient value in US utility assets committed to the collateral pool to meet its collateralization requirements with respect to the $250 million of working capital needed to meet peak cash working capital requirements

[8] Exh. 5; Sch. RD-1.

for US utility operations. The Company had not, at that time, achieved the separate hurdle needed to trigger a reduction in the interest rate under the Term Loan from 8.75 to 8.0. (Dobson Exh. 4, p. 10).

Since that time, on October 27, 2003, the Iowa Utilities Board ("IUB") issued its Order Not Disapproving Proposal for Reorganization, Denying Request for Extension of Authority and Requiring a Report in Aquila's companion docket number SPU-03-7. (Exh. 59). Pursuant to that order, the IUB approved the Company's proposal to contribute its Iowa utility properties to the collateral pool subject to a number of conditions. The value of those properties is still subject to an independent appraisal, but it is likely the definitive value of the Iowa properties thus contributed to the collateral pool will entitle the Company to the interest rate reduction under the standards set forth in the Term Loan.

The Company's request that its Missouri utility properties also be contributed to the collateral pool still meets meaningful business objectives of Aquila. Significantly, it is contractually obligated to pursue its Application under the provisions of the Term Loan. Thus, its failure to make "commercially reasonable efforts" to accomplish this task could be construed as a default on one of its affirmative covenants in the Term Loan.[9] Also, since the cash drawn down pursuant to the Term Loan is needed in part to meet the Company's peak cash working capital requirements for its US utility operations, including those in the State of Missouri, Aquila believes it is fair, equitable and appropriate that its utility properties in Missouri be committed to the collateral pool to support those needs. (Dobson, Exh. 4, p. 11). Aquila also believes that it is important that the credibility of its

[9] Dobson Exh. 4, Sch. RD-9, §5.13.

financial plan be bolstered by regulatory support for its restructuring objectives. Aquila's Chief Financial Officer, Rick Dobson, testified about the real, albeit intangible, positive perception the Commission's approval in this case will have for the Company in the capital markets.

> Q. (by Commissioner Murray) Is there any tangible benefit to Missouri ratepayers?
>
> A. Tangible is a - - I would answer that question it's difficult to say tangible. There's the intangible aspect of the fact that there's a marketplace signal if we're turned down potentially about our relationship with the Commission and the fact that they weren't willing to put our assets in a pool. (Tr. p. 470, l. 22-25; p. 471, l. 1-4).

Mr. Dobson later elaborated on this point.

> Q. (by Commissioner Forbis) You have the money. So there's no net negative effect on Aquila from the loan perspective?
>
> A. From a pure loan perspective, no, sir, there's not. And I only speak to the intangible effect of the marketplace looking to that as a relationship and trying to peer into our relationship with the Missouri Commission and say, well, I wonder if they have a good one or a bad one. And the reason I say that, Commissioner, is I get that question from investors . . . (Tr. p. 487).

This important sentiment has been echoed by John A. Cavalier, co-chairman of the Energy Group and Managing Director of the investment banking division of Credit Suisse First Boston ("CSFB") in New York City in a deposition taken in this case by intervenor, the State of Missouri, on October 9, 2003. Mr. Cavalier, a Harvard Business School graduate, has been in the investment banking business since 1983, at all times in the energy sector. Mr. Cavalier currently serves as a financial advisor to Aquila and in that capacity has made himself extremely familiar with the financial condition of the Company.

When asked at the time of his deposition how he thought the capital markets for the investment community would view a denial of Aquila's collateralization Application by the Commission, he responded as follows:

> I actually think the financial community [and] all classes of security holders of Aquila would view that as a very negative event. I think that it would signal a tension between the Commission and the company that it would view as unhealthy. One of the foremost consultants to the industry just published a piece saying the relationship with a Commission is actually a risk factor for a company.
>
> So I actually think that to the extent that the Commission reacts negatively to this request, that the debt community and the equity community would both view it as troublesome, and that the company would probably find it more difficult to attract capital than it would otherwise. And I really honestly believe that. (Deposition Tr. p. 110, l. 8-23).

It is apparent that the biggest risk for the Company at this time is not the possibility of default and insolvency (a circumstance which will be discussed in more detail in §II.F, *infra*) but, rather, the risk that adverse regulatory action may have in the way in which the capital markets view Aquila's ability to execute successfully on its financial plan.

The Company's management is well within its informed judgement to take these business considerations into account in seeking the authority from the Commission to commit its Missouri utility properties to the collateral pool. It is important that the capital markets and rating agencies see evidence of regulatory support for the continued successful execution of Aquila's financial restructuring plan at this critical juncture in the Company's history.[10]

[10] To date, Aquila has sold about $2.5 billion of non-strategic assets and debt has been reduced approximately by $1.4 billion. Mr. Cavalier stated that "the Company's actually done a phenomenal amount in a very short period of time . . ." (Deposition Tr. p. 55, l. 20-22).

D. Aquila's Application Should be Approved by the Commission

1. Aquila has met its burden of establishing that approval of the Application will not cause any change to the *status quo*.

By complying with all the applicable filing and procedural requirements, and by clearly demonstrating that the proposed transaction will result in no change in the *status quo* in the operations or regulatory status of Aquila's Missouri utility operations, Aquila has satisfied its burden of presenting a *prima facia* case that the transaction will not be detrimental to the public interest. No party is claiming that approval of the Application will result in any change in the rates Aquila is charging its Missouri utility customers. Additionally, there is no evidence whatsoever that approval of the Application will cause any impairment to the quality of service currently being provided.[11] Staff admits it has offered no evidence to establish an adverse impact on rates or customer service. (Wandel, Tr. p. 661).

The fact is that Aquila has been and continues to be focused on excellence in operations and customer service. The Company's financial plan includes steps to shield the customers of its regulated operations from any adverse impact as it executes on its financial plan. Customers will be protected from any adverse financial impacts by the maintenance of a capital allocation process that utilizes a hypothetical capital structures and long-term debt assignments to financially "ring-fence" its utility businesses. New or replacement debt assigned to utility operations will be priced at a comparable BBB credit rating. (Empson, Exh. 9, pp. 2-5).

[11] *See, Re Laclede Gas Company*, 16 Mo.P.S.C. (N.S.) 328 (1971).

Specific steps will ensure that quality customer service is maintained. Aquila has developed internal service quality metrics which include such functions as accuracy of meter reading, emergency response time, safety, SAIDI, SAIFI, CAIDI, generation availability, heat rates and call center performance. Status reports are prepared on a monthly basis and detailed internal service quality reviews are conducted quarterly. (Empson, Exh. 9, p. 5). This information has been voluntarily supplied to Staff on a quarterly basis within 45 days of the end of each quarter. (Keefe, Exh. 1, p. 3, l. 1-15). Aquila proposes to set scheduled quarterly meetings to discuss these service and performance indicators. (Carter, Tr. p. 221, l. 1-17).

The Commission's Staff offered the testimony of two witnesses, J. Kay Niemeier and James Ketter, addressing, respectively, call center performance and service reliability indices for Aquila. Ms. Niemeier offered testimony in which she purported to identify "a deterioration of customer service performance" with respect to Aquila's ACR and ASA performance objectives. (Niemeier, Exh. 1, pp. 10 and 12). There is, however, no connection whatsoever to the "trends" purported to have been identified by Ms. Niemeier and the authority sought by Aquila in this case. Significantly, Ms. Niemeier testified that the demanding customer service quality objectives Aquila has set for itself reflect the importance the Company's management places on good customer service. (Tr. p. 825, 6. 19-23).

First of all, the performance information offered by Ms. Niemeier is historical in nature and, therefore, cannot be caused by an encumbrance of the utility properties of

Aquila located in this state which has not yet been approved by the Commission. Ms. Niemeier admits the absence of any causal connection. (Tr. p. 829, l. 10-25; p. 830, l. 1-9).

As to the "trends" said to have been identified by Ms. Niemeier, the value of the data upon which she has relied is of questionable reliability. Ms. Niemeier did not perform any statistical analysis of Aquila's ACR or ASA performance for the years 2000 through May of 2003. She simply looked at the numbers and identified a trend by observation, not analysis. (Tr. p. 826, l. 1-24). Also, the numbers to which she refers are raw data. She did not make adjustments to the data to reflect the impact of a severe ice storm that struck Aquila's electric service territory in the winter of 2002 or the impact of a series of damaging tornadoes that struck Aquila's electric service territory during May of 2003. (Niemeier Tr. p. 828, l. 1-25; p. 829, l. 1-9). Each of these events was of such a scale and magnitude that they could only have had a measurable adverse impact on call center performance. (Niemeier, Tr. p. 828, l. 1-19). Tellingly, Ms. Niemeier readily agreed with Mr. Ketter's statement that adjusting data to remove the effects of major storms "will better reflect the operation of the system under normal conditions." (Niemeier, Tr. p. 827; Ketter, Exh. p. 3).

Ultimately, the ACR and ASA performance by Aquila for the years 2000 through May of 2003 have no causal connection whatsoever to the relief requested in its Application in this case and, moreover, the data related to call center performance, reflects unadjusted results that do not accurately reflect the operation of Aquila's system under normal conditions.

Finally, Aquila has taken affirmative steps to enhance regulatory transparency. Its new state-based utility organization provides an operational focus on the state. This

should enable the Commission to better understand and evaluate Aquila's Missouri businesses. Also, Aquila maintains a detailed cost allocation manual that is revised at least annually. Affiliate transaction procedures have been put in place to instill a discipline in the pricing of services or sales as between utility and non-utility businesses. Finally, Aquila has developed a Code of Business Conduct to provide employees guidelines to understand their ethical responsibilities. (Empson, Exh. 9, p. 7-8).

Collectively, these steps reflect the Company's commitment to protecting the customers of its regulated operations from any adverse impact as it restores its financial stability. Ratepayers have not been adversely impacted by recent events and, as importantly, they will not be adversely impacted by the contribution of the Missouri utility properties to the collateral pool. Continued excellence in customer service remains foremost and the Commission retains the ultimate ratepayer protection, the authority to review and pass upon any request for a rate increase.

2. No party has met its burden of submitting any evidence of a present and direct detriment to the public interest that will be caused by the Commission's approval of the Application in this case.

a. OPC has not Provided Proof of Detriment

The rebuttal testimony of OPC witnesses Robertson, Burdette and Busch, collectively, provide no basis whatsoever for denial of the Application. That this is so should be no surprise. It was not until after OPC's prepared rebuttal testimony was filed that the Commission issued its October 9, 2003, Order Denying Motion for Summary Disposition in which the Commission effectively determined that OPC's theory of the case (i.e. that there was no need for Aquila's Missouri properties to be contributed to the

collateral pool) was not the legal standard for denial of the Application. The upshot is that OPC has presented a misconceived case.

OPC witness Robertson's principal argument for denial of the Application is that Aquila already has sufficient collateral to satisfy its $250 million cash working capital requirements for utility operations, a fact that Aquila has not disputed. Not only is this the wrong legal analysis, it ignores other legitimate business reasons for approval of the Application identified by Aquila. (*See* §II.C., *supra*, p. 6).

Mr. Robertson also testified at page 29 of his rebuttal testimony (Exh. 35) that the Company's current financial condition is detrimental to the public interest, a fact that even if it were true would be beside the point because there is no causal connection between the encumbrance of the properties to support the Term Loan (which has not yet occurred) and the Company's current financial condition. Later on, at page 34 of Mr. Robertson's rebuttal testimony, he offers his opinion that Aquila's financial plan itself is detrimental to the public interest. Again, the allegation, even if true, establishes no causal connection between the active execution by Aquila of its financial plan to date and the encumbrance of Aquila's Missouri utility properties, which has not yet occurred.

Finally, Mr. Robertson offers his view that the collateralization proposal itself is detrimental to the public interest in that "those operations" (presumably Missouri utility operations) "will be at a severe disadvantage in future debt negotiations." (Robertson, Exh. 35, pp. 34-35). This allegation is simply wrong. The testimony of Aquila's CFO, Rick Dobson, points out that Mr. Robertson misapprehends the mechanics of Aquila's Indenture of Mortgage and Deed of Trust. Mr. Dobson has explained that the Indenture, as amended

and supplemented by the First Supplemental Indenture, specifically permits the issuance of additional senior secured debt in the amount of approximately $800 to $900 million beyond the $430 million amount of the Term Loan. (Dobson, Exh. 8, p. 3, l. 3-12). Aquila's ability to finance future utility needs with mortgage backed indebtedness will not be impaired by granting the authority requested in this case.

OPC's second theory is that Aquila has not demonstrated a need for cash working capital for its Missouri operations. In fact, Mr. Busch offers the stunning conclusion that Missouri is a net contributor to Aquila's working capital and, therefore, has no need for the proceeds from the Term Loan. (Busch, Exh. 33, p. 14, l. 20-23). This is a myopic and dangerous argument.

That Mr. Busch's argument is fundamentally flawed is illustrated by the fact that AmerenUE has a $772 million short-term credit facility despite the fact that its cash working capital calculation as determined in Case No. EC-2002-1 was initially determined by Staff to be $(744,292). (Lowndes, Exh. 3, p. 13, l. 4-7; Sch. CL-6). The simple fact of the matter is that each of the other major electric or gas utilities in this state have working capital facilities in place to meet peak day cash demands. (Lowndes, Exh. 3, Sch. CL-5 Corrected).

The $430 million Term Loan (together with a $100 million 364 day loan) was used to pay off the remaining balance of a $650 million revolving credit facility which had been utilized to meet the Company's peak working capital needs for all of its US networks operations, including those in the State of Missouri. (Dobson, Exh. 4, p. 9; Tr. p. 538-539). Staff witness Wandel confirmed that Aquila's current cost of service as determined in its

last rate case, Case No. ER-2001-672, included its line of credit for peak working capital needs. (Wandel, Exh. 13, p. 47, 6. 7-11). It is simply not plausible that Aquila's peak working capital requirements for its utility operations have simply expired as a consequence of exiting the merchant energy sector and other non-utility businesses. (Dobson, Tr. p. 539, l. 11-22). From a management perspective, it would be alarmingly imprudent not to have those contingencies covered by access to adequate cash reserves. While a utility does not expect to utilize cash at the peak projected level year round, or even on a regular basis, it must nevertheless ensure that it has the necessary financial reserves to meet its potential peak day cash demand. (Lowndes, Exh. 3, p. 3, l. 15- 19; p. 9, l. 14-19). This goes to the very core of its public service obligation.

Significantly, Mr. Dobson testified that he would have something like the Term Loan in place even if Aquila had only Missouri operations and those operations turned out to be a net provider of working capital. (Tr. p. 469, l. 1-20). Why? To provide for the inevitable unexpected revenue shortfalls and other emergencies that arise from time to time like the ice storms of 2002 and the tornadoes of 2003. (Dobson, Exh. 4, p. 12). Mr. Busch refers to costs of this nature derogatorily as "what-if scenarios" for which no financial planning is required or appropriate even though they have actually occurred. (Busch, Exh. 32, p. 16, l. 13-17). This is an astonishing and irresponsible recommendation. On its face, his testimony is entitled to no credence.

The purpose of Mr. Burdette's testimony is not immediately apparent. He claims to have identified two detrimental impacts that have been caused by Aquila's weakened financial condition, to wit, that Aquila must now prepay for natural gas and Aquila's higher

cost of capital brought on by the credit downgrades that have taken the Company below its former BBB rating. (Burdette, Exh. 31, p. 9, 12). With respect to the impact of Aquila's obligation to prepay for natural gas, the Company has stated that the prepays will be normalized for ratemaking purposes because it would not be appropriate to include this impact in a lead-lag study. (Lowndes, Exh. 3, p. 10). As such, ratepayers will not experience any adverse impact. As to the downgrade of Aquila's debt rating to below investment grade, this too has not adversely affected the public. All future debt assignments to its divisions will be at the same BBB rating the Company held before those downgrades. (Dobson, Exh. 4, p. 13).

Mr. Burdette also points to a "potential" detriment related to Aquila's request to commit its Missouri properties to the collateral pool. He suggests that it may reduce the Company's future "financial flexibility". (Burdette, Exh. 31, p. 14, l. 18-22). By his own admission, this is only a possibility. In other words, it may, or may not, be a problem. This is not compelling evidence of a present and direct detriment to the public interest. It is no more than an intellectual "jump ball." Moreover, the premise of Mr. Burdette's conclusion has been specifically rebutted by Mr. Dobson. (Exh. 8, p. 3, l. 3-12).

b. Intervenor SEIUA/AGP has not Provided Proof of Detriment

The testimony of SIEUA/AGP witness Gorman is no more compelling than that of Mr. Burdette. Mr. Gorman purported to offer his "expert" opinion that encumbering Aquila's Missouri utility properties to secure the First Mortgage Bonds issued under the Term Loan would preclude Aquila from establishing a dedicated line of credit for its Missouri utility

operations.[12] Mr. Gorman's exact statement is that securing a line of credit of this nature would be "problematic," a term that he defines as meaning "uncertain." (Gorman, Exh. 38, p. 5; Tr. p. 803, l. 2-8). In other words, Mr. Gorman does not know whether approving the Application in this case would have any impairment effect on future financing needs for Aquila's Missouri operations. (Tr. p. 805-807). This vacuous analysis falls far short of the requirement that the opposing party present compelling evidence of a present and direct public detriment.

Additionally, Mr. Gorman's opinion (or lack thereof) is based on no particular competence or expertise regarding the topic of utility financing, the topic about which he purports to have testified. Mr. Gorman has no first-hand experience whatsoever in making debt or equity placements nor has he had any experience working in a capital markets situation. (Tr. p. 793-802). His testimony is not competent or substantial evidence of any detriment to the public interest.

c. Staff has not Provided Proof of Detriment

Staff's evidence, too, fails to make any showing of a present and direct detriment to the public interest that will come about from the Commission's approval of the Application. Though couched in the jargon of detriment, the principal reasons cited by Staff as a basis for denial of the Application are merely echoes of and elaborations on the arguments made by OPC and SEIUA/AGP. Pledging assets to support a loan, the proceeds of which have already been drawn down by the Company, is a detriment

[12] The fact is that Aquila cannot obtain a collateralized line of credit just for its Missouri operations. Under its current legal structure, Aquila's utility divisions are not stand-alone legal entities. As a result, they cannot borrow funds on their own. (Dobson, Exh. 8, p. 5, l. 15-22).

according to Staff. (Wandel, Exh. 12, p. 15, l. 1-7). This is no more than code for the contention that Aquila has no need for the relief requested.[13] Even if true, it is no basis for disapproval.

Staff, too, argues that authorizing Aquila to commit its Missouri utilities works and system would impair the Company's future financing opportunities. (Wandel, Exh. 12, p. 15, l. 8-10). This is merely a reiteration of the flawed arguments of witnesses Burdette and Gorman. Further, Ms. Wandel's testimony assumes that Aquila's Missouri operations would be rated investment grade on a stand-alone basis. (Exh. 12, p. 5-15). However, this cannot possibly be known. Low profitability and operational cash flows of the Company's regulated operations in Missouri, taken together with the fuel cost risk caused by the lack of a fuel adjustment clause here, makes that question highly speculative at best. (Dobson, Exh. 8, p. 4, l. 1-12).

Staff argues that the Term Loan is not the most efficient means of financing the working capital needs of its Missouri operations. Ms. Wandel points out that these requirements have been met in the past by drawing on lines of credit or the sale of commercial paper. (Exh. 12, p. 15, l. 11-23; p. 16, l. 1-10). Aquila agrees that the Term Loan is not the ideal manner in which to meet its liquidity needs but it is unfortunately the only option now available to the Company. (Dobson, Exh. 4 p. 14; Lowndes, Exh. 3, p. 3, l. 15-17). Ultimately, this criticism is irrelevant. Aquila is managing the Term Loan internally as if it were a revolver, like the $650 million facility it replaced. It is held at the corporate level and Aquila functions as the bank for business operations which will be

[13] Actually, it isn't even a code. Staff is forthright that it opposes the Application because it is unnecessary in that Aquila has already received the loan proceeds. (Wandel, Tr. pp. 654-656).

charged for funds only when needed and the cost to be based on a BBB investment grade utility. (Dobson, Exh. 4 p. 13, l. 16-24; Exh. 8, p. 1-2; Empson, Exh. 11, p. 5, l. 4-8). Also, this is an existing circumstance. As such, it cannot have been caused by an encumbrance not yet approved by the Commission.

Staff, like OPC, contends that Aquila has overstated its need for peak working capital for its Missouri utility operations. (Wandel. Exh. 12, p. 16, l. 11-17). Staff, however, does not dispute that Aquila has a peak cash working capital requirement for its regulated operations so this latter criticism amounts to no more than quibbling about the amount of the need, not to whether there is a need. (Wandel, Exh. 12, p. 10-11). To reiterate, the determination of need is one reserved by law to the Company.[14]

Staff contends the Company has no need to encumber its Missouri properties noting, correctly, that the appraised value of utility assets located in the States of Nebraska, Michigan and Colorado are enough to support Aquila's $250 million working capital requirement under the Term Loan. (Wandel, Exh. 12, p. 16, l. 18-23). It is a fact that is nevertheless irrelevant to the central question, that is, will approval of the mortgage of the Missouri properties cause a present and direct detriment to the public interest?

Staff's proportionality argument at page 16 of Ms. Wandel's rebuttal testimony has a superficial appeal but it is premised on the false assumption that the amount by which the value of Aquila's Missouri properties exceeds its state-specific working capital needs will be taken out of circulation for other future financing needs. Again, as explained by Mr. Dobson, this is simply not the case.

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[14] *See*, §II.B., *infra*.

As noted previously, Staff's seventh objection apparently has been mooted by a recent action of the IUB.

Perhaps the only issue raised by Staff that has some conceivable bearing on the topic at hand is its stated concern about regulated assets being used to support non-regulated activities. This, however, is a conceptual, not real, concern.

Aquila considered this concern during the development of its financial plan. Consequently, Aquila has specifically aligned its non-regulated collateral under the Term Loan to meet non-regulated cash needs and, conversely, it has aligned regulated assets with its regulated cash working capital needs. (Dobson, Exh. 4, p. 10, l. 18-25). There is no subsidy because Aquila has put in place this alignment. Also, Aquila is committed to maintaining this collateral alignment as it executes on the various components of its financial plan. As such, it will periodically reexamine its liquidity needs as against the collateral pool to ensure proper collateral alignment. (Dobson, Exh. 4, p. 11). In any event, the Commission already has in place appropriate safeguards against any possible subsidy scenario. These are codified in its affiliate transactions rules. *See*, 4 CSR 240-20.015 (electric); 4 CSR 240-40.015 (gas); 4 CSR 240-80.015 (steam). No additional action is needed.

d. Intervenor the State of Missouri has not Provided Proof of Detriment

The State of Missouri offered no evidence whatsoever. Its arguments are simply derivative of those of the other objectors and, consequently, are similarly deficient.

e. The Objections do not Establish a Present and Direct Detriment

There are so many hedge words and qualifiers appearing in the testimony of OPC, Staff and the other parties that the speculative nature of the objections is self-evident. "Potential" issues and "problematic" concerns are not a sufficient evidentiary basis for disapproval. They are too tenuous and remote to be considered reliable. Staff witness Bible's concern that this would "set into motion a course of events" that will inevitably lead to some unspecified bad thing is a classic "parade of horribles" argument that does not justify a denial of the Application. To deny the Application on this speculative basis would unreasonably interfere with Aquila's constitutionally protected right to deploy its properties to its best financial and business advantage.

E. Creating a Mortgage or Encumbrance on Public Utility Property Located in This State is Not Itself a Detriment to the Public Interest

Permeating the spaces between the lines the testimony and other evidence opposing the Application in this case is a disturbing undercurrent, that is, the suggestion that a mortgage on utility property is, by definition, a detriment to the public interest.[15] This is not so and legally, it cannot be so.

Section 393.190 RSMo expressly authorizes the Commission to permit a gas corporation or electrical corporation to mortgage or encumber "the whole or any part of its franchise, works or system, necessary or useful in the performance of its duties to the public" unless doing so would be detrimental to the public interest. *See*, *State ex rel. City*

[15] This undercurrent actually seethed to the surface momentarily during the hearing when Staff's principal witness, Joan Wandel, stated that in her view the encumbrance itself would be a detriment to the public interest! (Tr. p. 674, l. 11-16). This view was later contradicted by Staff witness Ron Bible, the Commission's Chief Financial Analyst, conceded that the pledge of assets to the collateral pool would not itself be an event that would cause a detriment. (Tr. p. 742).

of St. Louis, supra. It is clear that the General Assembly would not have empowered the Commission to permit the use of encumbrances or mortgages to finance a utility's operations if these common commercial devices were inherently detrimental to the public interest. Because the Commission has specific statutory authority to authorize mortgages on public utility property in this state, there is no principled basis whatsoever for a factual finding that mortgages are by definition detrimental to the public interest.

Practical experience also provides a compelling rebuttal to this contention. The use of mortgage backed debt by this Company, and many other utilities in this state, has been a long and respected tradition. Aquila, when it was known as UtiliCorp United Inc., and, prior to that, as Missouri Public Service Company, frequently issued mortgage backed indebtedness to fund its utility operations in each case with the approval and consent of the Commission. Schedule RD-7 to Rick Dobson's direct testimony identifies 43 separate cases stretching back to as early as 1928. As the Commission is no doubt aware, other Missouri utilities including Missouri-American Water Company, Laclede Gas Company, AmerenUE, Citizens Power, Kansas City Power & Light Company and The Empire District Electric Company routinely issue indebtedness backed by a mortgage on their properties. The level of this secured debt ranges from 18.8% for Great Plains Energy to 100% for Laclede Gas Company. (Dobson, Exh. 8, p. 5, l. 1-7).

Secured financing has long been recognized as a valuable tool in utility finance as a source of low cost debt capital from the financial markets. (Burdette, Tr. p. 846). This is confirmed by the fact that there have been over 40 separate issuances of secured indebtedness since January 2002 representing a cumulative total of more than $12.4

billion. (Dobson, Exh. 4, Sch. RD-6). Practical experience has confirmed the value of this tool by the simple fact that customers have not been harmed by this practice. To the contrary, customers of Missouri utilities have affirmatively benefitted by the fact that utilities have had access to low cost debt capital.

Mortgage backed debt is often the most affordable form of debt capital because it represents less of a risk for creditors. All creditors have potential claims against a debtor's assets. The creditor with a mortgage backing its note, however, has a much better chance of having its claims paid in full in the event of an insolvency or bankruptcy then does an unsecured creditor. Because the risk to the creditor is lower, the cost of capital borrowed from the secured creditor is often lower than unsecured obligations. Consequently, a mortgage is merely a commercial convenience available to debtors and creditors.

F. The Risk of Insolvency, Default and Bankruptcy

There has been a good deal of discussion during the course of this case about the risk of insolvency, a resulting bankruptcy filing by Aquila and how the Company's contribution of its Missouri utility assets to the collateral pool would play out in such a scenario. Generally, these concerns have been overstated, in some circumstances to create an unwarranted sense of crisis where none actually exists. These considerations present no practical reason not to approve the Application.

It should come as no surprise to the Commission that the Term Loan contains various events of default and the Indenture contains commercially customary remedies to the creditors in an event of default. These provisions are standard clauses for secured financings of this nature and, importantly, are expressly subject to applicable law, including

the provisions of the Public Service Commission Law of Missouri (the "Act"). Consequently, the Commission's authority to regulate Aquila's operations are not (and cannot be) impaired by any of these provisions.[16]

The customary provisions in the Indenture providing the possible remedies of seizure and sale of the encumbered properties are no cause for alarm or concern on the part of the Commission. As noted above, any such sales remain subject to the Commission's authority to regulate whoever owns or controls the utility plant[17] and to approve any subsequent sale of the assets. This latter circumstance receives some validation from a ruling in 1993 of the Missouri Court of Appeals for the Eastern District of Missouri *State ex rel. Missouri Cities Water Company v. Hodge*, Case No. 63795.[18] This was an original proceeding in prohibition to prevent Judge Edward D. Hodge of the Circuit Court of Audrain County from enforcing an order of condemnation authorizing the City of Mexico ("Mexico") to acquire the water utility operations of Missouri Cities Water Company ("Missouri Cities"). The Appeals Court concluded that while Mexico had statutory authority to condemn Missouri Cities' waterworks system, Mexico had not obtained from the Commission the necessary authority under § 393.190.1 RSMo for the transfer of the utility's system to the municipality.

> [W]e find that the language used in that statute would include a transfer occasioned by a municipality's exercise of the power of eminent domain . . . **While the transfer in this instance may be involuntary, the language of §393.190.1 does encompass it**. (Emphasis added.)

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[16] It is well-established that the provisions of the Act supercede any contrary contractual provision to which the utility is a party. *May Department Stores Co. v. Union Electric Light & Power Co.*, 107 S.W. 2d 41, 341 Mo. 299 (1937); *State ex rel. Capital City Water Co. v. Public Service Commission*, 850 S.W. 2d 903 (Mo. App. 1993).

[17] *See*, § 386.250 RSMo 2000.

[18] This was an opinion of the Court's Writ Division and was not published in the official reports. A copy of the slip opinion will be provided to the Commission upon request.

The Court made its preliminary writ permanent and found that Commission authorization should be sought before condemnation proceedings are commenced.[19]

Also, the Indenture itself expressly reserves to the Commission its authority to rule upon any sale by a secured party. The § 9.04 Power of Sale provisions in the Indenture are "subject to the provisions of §9.16." That latter section states that the exercise of any such power "shall not be in conflict with any applicable law." (Dobson, Exh. 4; Sch. 10, pp. 75, 80).

Practically speaking, lenders want to be paid the principal and interest on a loan to maturity. Consequently, they are not looking for a pretext to force a default, seize collateral and operate a utility. A violation of a covenant may be waived by the lender at a cost to the borrower, particularly if the borrower is in fairly sound financial condition. There is good reason for this. Triggering a default on the Term Loan would likely trigger cross-defaults on all unsecured indebtedness and forcing the Company into bankruptcy where asset seizures would not be able to occur because of the automatic stay. (Dobson, Tr. p. 424, 515).

Ultimately, these alarmist default and foreclosure scenarios are only of academic interest. In the real world of debtors and creditors remedies where utilities like Aquila are concerned, a material default brought about by a financial crisis would almost certainly play out in the context of proceedings in the federal Bankruptcy Court.

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[19] Subsequently, the Missouri Supreme Court concluded that the City of Mexico did not have statutory authority to acquire the waterworks of Missouri Cities by eminent domain thus obviating the need for the lower court's ruling on the applicability of § 393.190.1 RSMo. *See, State ex rel. Missouri Cities Water Company v. Hodge*, 878 S.W. 2d 819 (1994). Nevertheless, the opinion of the Court of Appeals remains instructive.

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In any event, a bankruptcy filing of a public utility brought on by insolvency would not involve a liquidation of the utility's assets. The value of a utility is not found in its scrap value but, rather, in its value as a going concern that generates cash from operations. This

makes a Chapter 7 liquidation filing highly unlikely because it would entail the cessation of business activities. There will not be any auctions on the courthouse steps.

In a Chapter 11 reorganization, on the other hand, the filing company typically survives as an operating business. Its debts are paid through a "plan" which must be approved by the bankruptcy judge. Generally, the debtors, officers and directors continue to control the company throughout the bankruptcy process. The federal Bankruptcy Code provides a listing of priority for the use of distribution of payment to the company's creditors through a Chapter 11 plan. The priorities are set forth at 11 U.S.C. § 507 which dictates who gets paid and in what order. Secured creditors are paid first to the extent of the value of their security. Unsecured creditors are next in line for payment although within the category of unsecured creditors, some are more equal than others. Typically, the bankrupt company emerges at the end of the process with its financial obligations substantially reduced and/or restructured. (Dobson direct, p. 15).

The realistic remedy for an insolvent utility is to invoke the protection of the federal Bankruptcy Court through a Chapter 11 plan of reorganization. Actual experience makes it abundantly clear that financially troubled utilities always avail themselves of this avenue of relief. Pacific Gas and Electric ("PG&E"), the utility unit of PG&E Corporation, filed for reorganization under Chapter 11 of the United States Bankruptcy Code after spending billions of dollars in revenue to purchase electricity during what has become known as the "California Energy Crisis." Other major electric utility companies and one major natural gas utility holding company filed for protection under Chapter 11 of the Bankruptcy Code prior to PG&E's filing. Public Service Company of New Hampshire filed for protection under

Chapter 11 of the Bankruptcy Code in 1998. El Paso Electric Company filed under Chapter 11 in 1992. Cajun Power Electric Cooperative, Inc. filed for protection under Chapter 11 in 1994. Columbia Gas Systems, Inc. filed for Chapter 11 bankruptcy protection in 1991. These cases, and their outcomes, have been discussed in an excellent article entitled Chapter 11 Reorganization of Utility Companies recently published in Volume 22 of the **Energy Law Journal** commencing at page 277.

Additional confirmation can be found in the deposition testimony of Mr. Cavalier in which he discusses another case that has particular relevance because it has arisen in the context of a CSFB financing facility similar to that of Aquila's Term Loan.

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* * * * *

Okay. I think that we provided similar facilities to Dynergy, Center Point, and Northwestern Corporation, Northwestern Public Service.

Q. And what happened in those - - did those three companies each default on an agreement?

A. No. The only one that has in fact default[ed] is Northwestern Public Service Company.

Q. And what did Credit Suisse First Boston do when Northwestern Public Service Company defaulted?

A. In the case of Northwestern Public Service, they filed a voluntary [petition] for bankruptcy under Chapter 11. We have not called [in] the loan. They received some debtor in possession financing from another financial institution, and I believe that the lawyers representing the financial institutions who provided the credit facility to Northwestern have simply taken action to ensure that that facility has the same legal status as the debtor in possession financing, so they have not sought to recover those moneys. They are just waiting for the voluntary plan of reorganization to be filed and approved by

the bankruptcy court. And it's probably, you know, a very clear example of the worst case scenario.

Q. So Credit Suisse First Boston didn't - - and I'll use the verb foreclose - - on any property?

A. No, sir.

Q. Did it have the right to foreclose on Northwestern?

A. I would have to look at the terms specifically, but my best assessment would be yes. (Deposition Tr. p. 24, l. 15-25; p. 25, l. 1-22).

Clearly, the few recent real-world examples of utility insolvencies have resulted in Chapter 11 reorganization filings under the federal Bankruptcy Code, typically with operations continued uninterrupted with a debtor-in-possession at the conclusion of which the filing company emerges from the process after a Court-supervised financial restructuring.

Although regulatory commissions may have their authority to supervise and approve utility reorganizations and restructurings somewhat constrained by the provisions of the federal Bankruptcy Code, the Commission would retain substantial ongoing authority to oversee and regulate the rates and terms and conditions of service provided by the utility even in the context of a bankruptcy.[20] Because the purpose of the Term Loan was to address critical liquidity concerns and facilitate a financial restructuring outside of bankruptcy, it should be viewed not as a regulatory risk but, rather, as a process that has preserved the Commission maximum breath of authority to regulate Aquila's operations. Aquila's financial plan does not represent additional risk for regulated operations. To the

[20] The federal Bankruptcy Code governs reorganizations "notwithstanding any otherwise applicable nonbankruptcy law." 11 U.S.C. §1123(a)(5); *Re Pacific Gas and Electric Co.*, 283 B.R. 41 (N.D.Cal. 2002). It would appear, however, that regulation of rates and service quality are police power exceptions to the automatic stay while the bankruptcy is pending and no plan of reorganization that proposes a rate change may be approved without the approval of the utility regulatory commission having jurisdiction over the rates charged by the debtor. *Id.*; 11 U.S.C. §1129(a)(6).

contrary, the financial plan has preserved the Commission's oversight of all aspects of Aquila's regulated Missouri operations.

G. The Commission May Mitigate any Detrimental Impact by the Imposing Conditions on its Approval

A recent decision of the Commission makes it clear that an identified detrimental consequence to a transaction for which approval is sought under §393.190.1 RSMo that is either offset by benefits derived or can be mitigated by conditions, can be approved consistent with the "no detriment" standard. *See*, *Re Gateway Pipeline Company*, ___ Mo.P.S.C. 3d ___, 201 Mo.P.S.C. Lexis (2001).[21] It is Aquila's position that no party has presented any evidence whatsoever of a present and direct detriment to the public interest that will be caused by the mortgage by Aquila of its electric, natural gas or steam systems under the terms of the Indenture.

Without in anyway conceding the existence of a detrimental impact, Aquila contends that any such impact is either (1) offset by commensurate benefits or (2) can easily be mitigated by appropriate conditions. The benefits are continued progress on the execution of Aquila's financial plan outside of the context of bankruptcy and, also, the favorable perception that an approval by the Commission will have in the financial markets thus enhancing its access to the capital markets. Though intangible, the benefits are real, and important.

Necessarily, the type and number of conditions will be a function of the detriment identified. For example, much has been made of Aquila's request that any approval be applicable to any replacement facility not exceeding the $430 million of the Term Loan.

[21] Copy supplied upon request.

Aquila is not opposed to a condition that it be required to file for and obtain approval to subject its utility properties in this state to the lien of a mortgage for any replacement or substitute loan.

Aquila is not opposed to requirements similar to those contained in a Stipulation and Agreement and approved by the Colorado Public Utilities Commission as conditions to its June 20, 2003 approval of Aquila's collaterlization request in that State.[22] Those conditions (as may be applicable in Missouri), in conjunction with Aquila's comprehensive regulatory commitments, as outlined by Aquila witness Jon Empson and described above (*see*, §II.D.1., *supra.*), will insulate the Missouri ratepayers from any perceived detrimental consequences.

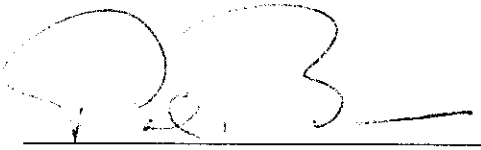
III. CONCLUSION

Under the controlling law in this state, the Commission is required to approve Aquila's Application to contribute its Missouri utility properties to the collateral pool supporting the Term Loan unless it has been presented with compelling evidence of a present and direct detriment to the public interest that will result from the approval of its Application. As has been shown herein, no such evidence of a public detriment has been offered by the parties opposing the Application in this case. Consequently, there is no lawful basis for disapproval. To the contrary, there are good practical business and regulatory reasons for approval of the Application in this case. The Company has stated its business objectives supporting its financial plan and the need for security for the Term Loan. The perceptions of the financial community to the Commission's decision in this

[22] Robertson, Exh. 35, Sch. TJR-12, l. 1-30.

case is an important consideration at this critical juncture in the Company's history. To the extent any detriments may have been identified, they are inconsequential and/or short-term in nature and can easily be mitigated by appropriate conditions. Aquila's financial plan presents no risk to its regulated operations. Approval of the Application will facilitate continued restructuring of the Company's financial obligations outside of the context of a bankruptcy and, consequently, the Application should be approved.

Respectfully submitted,



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I hereby certify that a true and correct copy of the above and foregoing document was delivered by first class mail or by hand delivery, on this 8th day of December 2003 to the following:

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