

Exhibit No.:

Issues: Capitol Costs

Witness: Susan D. Abbott

Sponsoring Party: Aquila Networks-MPS

Case No.: ER-2004-0034

Before the Public Service Commission
of the State of Missouri

Rebuttal Testimony

of

Susan D. Abbott

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
REBUTTAL TESTIMONY OF SUSAN D. ABBOTT
ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS [REDACTED]
CASE NOS. ER-2004-0034 [REDACTED]**

1 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 A. My name is Susan D. Abbott. My business address is 280 Park Avenue, New
3 York, New York 10017.

4 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT POSITION?**

5 A. I am a Managing Director with New Harbor Incorporated.

6 **Q. WHAT IS YOUR EDUCATIOINAL BACKGROUND?**

7 A. I have a B.A. from Syracuse University, and an M.B.A. in finance from the
8 University of Connecticut.

9 **Q. PLEASE DESCRIBE YOUR PROFESSIONAL BACKGROUND.**

10 A. From 1977 until 1982 I was a Senior Investment Analyst with Aetna Life &
11 Casualty Company in Hartford, Connecticut, analyzing and making investment
12 recommendations in electric and gas utilities in the United States. From 1982
13 until 2002 I worked for Moody's Investors Service, first as a Senior Analyst in the
14 Utilities Group, and for my second 10 years there, as Managing Director of the
15 Power Group. I was a faculty member of the Public Utilities Executive Course at
16 the University of Idaho from 1994 until 2003. I have also been a guest lecturer at
17 Wharton Business School, and the University of Connecticut Business School.
18 Currently, I am a Managing Director with New Harbor Incorporated, providing
19 classic financial advisory service to participants in the electric sector.

1 **Q. WHAT WAS THE FUNCTION OF THE POWER GROUP AT MOODY’S?**

2 A. The Power Group was responsible for analyzing the financial condition and
3 prospects for all investor owned utilities, independent power producers, and
4 power projects in North and South America, primarily focused on the U.S.,
5 Canada, Mexico and Brazil. The opinions derived from those analyses were
6 communicated to the fixed income investing community in the form of ratings.
7 In addition, the group rated the debt of U.S. investor owned water companies, and
8 electric cooperatives. Additional responsibilities included a matrix relationship
9 with non-U.S. analysts who covered power companies outside the Americas. We
10 provided fixed income investors with our opinions, in both written and oral form,
11 about how well equipped companies in the electric sector were to pay their
12 financial obligations in a timely manner.

13 **Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE OR BEEN AN EXPERT**
14 **WITNESS IN PROCEEDINGS BEFORE REGULATORY BODIES?**

15 A. Yes. I have filed testimony for Oklahoma Gas & Electric in a case it eventually
16 settled with the Oklahoma Corporation Commission, and have testified on behalf
17 of TECO Energy before the Arizona Corporation Commission. I have also
18 testified on behalf of Southern California Edison before the California Public
19 Utilities Commission.

20 **Q. WHAT IS THE NATURE OF YOUR TESTIMONY IN THIS CASE**
21 **BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION**
22 **(“COMMISSION”)?**

1 A. I have been retained by Aquila, Inc. (“Aquila” or the “Company”) to render an
2 opinion as to how the current Missouri Public Service Commission Staff (“Staff”)
3 and Office of Public Counsel recommendations for the Missouri Public Service
4 (“MPS) [REDACTED] operating divisions of Aquila,
5 will affect the creditworthiness of the Company from the point of view of a rating
6 agency and/or fixed income investor, and in this regard rebut the ultimate
7 conclusions and recommendations of Staff witness David Murray as well as
8 Office of Public Counsel witness Mark Burdette. Since the regulatory
9 environment is one of the most important issues investors and rating agencies
10 look to when assessing utilities, it is of paramount importance that regulatory
11 decisions are made with a full understanding of the consequences of those
12 decisions to the company at issue, and thus to its ratepayers. Returns must be fair
13 and allow for sufficient cash flow to maintain financial health, and costs that
14 reflect current realities in the marketplace must be allowed. Otherwise, the
15 utilities’ financial flexibility will be threatened and access to capital at a
16 reasonable cost will be severely limited, potentially affecting the ability of the
17 company to provide ratepayers with the same high level of service to which they
18 are accustomed.

19 **Q. HOW DID YOU PROCEED IN DEVELOPING YOUR ANALYSIS AND**
20 **REBUTTAL TESTIMONY?**

21 A. I did a classic rating agency/fixed income analysis. It is analogous to an
22 individual’s personal finances. If a person has a salary that allows him or her to
23 pay all the bills each month, and have something left over, that person is

1 financially sound. If there is a shortfall of cash relative to the bills that need to be
2 paid, that person is going to have difficulty getting anyone to give him or her a
3 new car loan or a mortgage.

4 When doing a fixed income style analysis, an analyst examines, among other
5 things, the lines of business the company is in in order to determine business risk,
6 which I will discuss in more detail later; the regulatory and political environment
7 in which it operates in order to understand the likely levels of cash flow that can
8 be generated within the business; the company's financial structure, liquidity,
9 cash flow and fixed obligations; and the financial metrics that result therefrom. A
10 rating agency or fixed income analyst will take those elements, and determine 1)
11 whether the company's current and future financial condition provides adequate
12 cash flow to pay all of its obligations *and* make the capital expenditures necessary
13 to maintain or improve the level of service it provides its ratepayers, and still have
14 something left to enable it to deal with unexpected events; and 2) how the
15 company in question compares to other companies in the sector. That comparison
16 is important because all companies in a sector are in competition with each other
17 for investors' dollars. Therefore, comparisons are made between the company
18 being examined and its peers, not only in its home state, but other jurisdictions as
19 well. Fixed income investors have many choices, and will weigh whether the
20 prospects for one company are better or worse than the prospects for another
21 based on issues like the regulatory and economic environment in which the
22 companies operate. Rating agencies look at companies within a sector in a
23 relative way as well. While there is a general view about the appropriate absolute

1 rating for a sector, ratings of individual companies within that sector are relative
2 to one another.

3 **Q. ARE YOU SPONSORING ANY SCHEDULES WITH YOUR**
4 **TESTIMONY?**

5 A. Yes. I am sponsoring Schedules SDA-1 through SDA-3.

6 **Q. WERE THESE SCHEDULES PREPARED BY YOU OR UNDER YOUR**
7 **DIRECTION?**

8 A. Yes.

9 **Q. PLEASE SUMMARIZE YOUR CONCLUSIONS.**

10 A. It is my opinion, based on 25 years of experience in analyzing electric utilities in
11 the U.S., that the financial metrics for both MPS [REDACTED] resulting from the
12 current Staff and Public Counsel recommendations are inadequate to justify
13 investment grade status for either division were they stand-alone entities. In
14 addition, since MPS [REDACTED] are core assets for Aquila in its “back to basics”
15 strategy, non-investment grade metrics for the divisions will only preclude Aquila
16 from ever attaining investment grade status itself. In addition, the
17 recommendations are out of line with other recently decided cases around the
18 country which will, in itself, make rating agencies and investors view investments
19 in Aquila negatively. In fact, Moody’s carries a negative outlook on its ratings of
20 Aquila, in part because “future projected revenues and cash flow of its utilities are
21 contingent upon favorable regulatory decisions regarding its pending rate cases.”¹
22 What this means is that an unfavorable regulatory decision, meaning one that

¹ Global Credit Research Opinion Update, Moody’s Investors Service, December 10, 2003

1 would result in thin or inappropriate financial performance for a healthy utility,
2 could easily result in a further downgrade of Aquila.

3 Both the investing community and the rating agencies have responded positively
4 to Aquila's return to their regulated roots. I believe it is particularly important
5 that the Commission be advised of the far-reaching impact an order perceived as
6 negative by the financial community can have on a utility's creditworthiness.

7 **Q. WHAT IS CREDITWORTHINESS?**

8 A. Creditworthiness is well described by Thomas McGuire, the longtime head of
9 Moody's Corporate Finance business, at a Conference Board meeting in 1978.
10 He said "You tell a sound credit by the fact that its disposable cash inflows are
11 always perfectly adequate to meet the cash claims on them. It is never really
12 forced to borrow; it always chooses to borrow in order to take advantage of a
13 growth opportunity. The corporation's survival is never allowed to depend on the
14 retention of lender confidence." The important elements of this definition of
15 creditworthiness are that 1) there is always enough cash generated by the business
16 to pay all cash expenses which include interest and principal on debt; 2) that a
17 creditworthy company can generate enough cash to make the investments it wants
18 or needs at will; and 3) a creditworthy company generates enough cash to ride
19 out market disruptions and doesn't have to depend on its lenders to provide the
20 cash needed to pay its cash expenses or make its necessary investments. In the
21 electric sector sufficient cash to cover capital expenditures, which represent this
22 sector's opportunity for investment, is a hallmark of a healthy company.

1 **Q. WHAT DO INVESTORS AND RATING AGENCIES EXAMINETO**
2 **DETERMINE IF A COMPANY IS CREDITWORTHY?**

3 A. Investors are most interested in whether a company can pay its principal and
4 interest in a timely manner. Rating agencies look for that as well, and assign
5 higher ratings to those companies whose financial performance is more
6 predictable and stable than those whose performance is more erratic. A regulated
7 industry like vertically integrated, regulated utilities have demonstrated more
8 predictable, stable financial results than, for instance the merchant power sector,
9 which is highly affected by economic forces out of its control. That steadiness
10 and predictability has allowed the regulated electric sector to enjoy more
11 consistently investment grade ratings over the years than some other economic
12 sectors like home building or healthcare. Uncertainty is anathema to investors
13 and rating agencies. Investors require higher interest rates to protect themselves
14 from the uncertainties they face with a company with lower credit quality, or one
15 whose performance is less predictable. For a utility, higher interest rates mean
16 higher rates to ratepayers, and/or fewer dollars to invest in plant and equipment to
17 serve those ratepayers.

18 **Q. WHY IS CREDITWORTHINESS IMPORTANT?**

19 A. The level of creditworthiness a company carries dictates not only the cost it will
20 pay for borrowed money, but the level of access it will have to the credit markets.
21 In addition, counterparty credit, that is the willingness of trade creditors to
22 advance credit, shrinks as a company's creditworthiness diminishes. For
23 illustrative purposes, the cost of money for an investment grade company on

1 January 15, 2004 was 125.3 basis points higher than U.S. Treasury bonds. For a
2 non-investment grade company, the yield spread was 449.1 basis points higher
3 than comparable U.S. Treasury bonds.² That means that if a company was rated B
4 instead of BBB, it costs them an additional \$3,280,000 for every \$100 million it
5 borrows. This directly impacts the consumer in that the cost of funds is included
6 in rates. So the higher the cost of money, the higher rates will potentially be.
7 Access to the credit markets is affected by creditworthiness. Many funds,
8 certainly insurance companies, and other investing institutions are restricted by
9 charter, law or economics from investing in lower rated companies. For instance,
10 insurance companies don't invest large amounts of money in non-investment
11 grade companies because they are required to set aside a "reserve" in the form of
12 higher equity balances to protect against their investing risk. The higher the risk,
13 the higher the reserve, the more equity the insurance company must carry on its
14 books. Therefore, it restricts itself primarily to investment grade credits in order
15 to maximize its own financial metrics. The Federal Reserve Board restricts its
16 members to investing in companies carrying the four highest ratings, (AAA/Aaa,
17 AA/Aa, A/A and BBB/Baa – essentially investment grade) while the Department
18 of Labor allows pension funds to invest in commercial paper that carries one of
19 the three highest ratings (A-1/P-1, A-2/P-2, A3/P-3 – there is no commercial
20 paper market for non-investment grade credits). Many fiduciaries are restricted
21 by state laws to investments in a "legal list" of securities which usually requires
22 investment grade ratings among other things, and some are restricted by the
23 "prudent man rule" that dictates that a "trustee may invest in a security if it is one

²Standard & Poors Bond Index as of January 15, 2004

1 that would be bought by a prudent man of discretion and intelligence, who is
2 seeking a reasonable income and preservation of capital”³ This leads most funds
3 who are not otherwise regulated to invest in credits rated no lower than A, while
4 others restrict themselves to those no lower than BBB-. As a company’s
5 creditworthiness worsens, the pool of money available to it is not only more
6 expensive, but much smaller.

7 **Q. WHAT DOES AN ANALYSIS OF CREDITWORTHINESS ENTAIL?**

8 A. A fixed income analyst, those who examine creditworthiness, whether as an
9 institutional investor or for a rating agency, looks at two broad categories of risk:
10 business risk, and financial risk.

11 **Q. PLEASE DISCUSS BUSINESS RISK.**

12 A. An examination of business risk includes looking at industry characteristics and
13 the challenges and opportunities posed thereby; management expertise to deal
14 with those challenges; and regulation and how it will support or hinder a company
15 in its quest to meet objectives including operating and financial performance
16 goals. Some of the important elements that fixed income analysts focus on to
17 determine the level of business risk that exists for any given company are
18 prospects for growth, stability or decline, and the pattern of the business cycle.
19 Particular to the electric utility industry are considerations of the fact that capital
20 investments tend to have long lead times and large capital requirements. These
21 issues heighten business risk and the “examination of cash flow adequacy
22 assumes major importance.”⁴ Many factors influence cash flow adequacy, such

³ NYSE Glossary

⁴ Corporate Ratings Criteria, Standard & Poor’s, November 13, 2003

1 as weather, load growth etc. However, regulatory decisions are by far the most
2 influential factor in this regard.

3 Moody's Investors Service views business risk as a major issue. It assumes the
4 highest levels of business risk for utilities operating in unstable markets like
5 merchant energy, with the lowest level ascribed to distribution companies with no
6 load responsibilities. Moody's also ascribes higher levels of business risk to
7 those utilities operating in jurisdictions where regulation is problematic, like
8 California.

9 Standard & Poor's is very specific about business risk. It categorizes each
10 company it rates according to its business risk. The categories range from 1, the
11 lowest business risk, to 10, the highest. The propensity of vertically integrated
12 regulated electric and combination utilities fall into business risk categories
13 between 4 and 6. Companies with substantial unregulated activities are assigned
14 "7" to "8", and no electric company has been assigned less than a "3". Empire
15 District is ranked a 5, Kansas City Power & Light a 6, and Ameren a 5.

16 **Q. PLEASE DISCUSS FINANCIAL RISK**

17 A. The other broad category of risk is financial risk. This entails an examination of
18 the financial performance of a company. Items such as capital structure, cash
19 flow as a percentage of outstanding debt, pre-tax interest coverage and cash flow
20 coverage of interest or debt service are some of the more important statistics.
21 The capital structure indicates what level of fixed obligation a company has. The
22 higher the level of debt, the more cash that is needed to pay the interest on it
23 (assuming interest rates between companies are comparable). In addition, the

1 more debt a company has, the higher the financial risk is that when that debt
2 comes due, the company will be able to either pay it off (not the common practice
3 unless a company is intentionally reducing their debt load as a percentage of
4 capitalization) or roll it over (in other words, borrow new debt in the marketplace
5 to pay off the old debt – a most common practice).

6 Weighed against the amount of debt outstanding is cash flow. These financial
7 metrics are commonly called “coverage” numbers. They indicate how robust the
8 company’s cash flow is relative to its fixed obligations. “FFO/debt”, or funds
9 from operations as a percentage of outstanding debt indicates how long it would
10 take for a company to repay all of its debt if it so chose. While it is unlikely that
11 that would happen, the metric provides an indication of how strong cash flow is
12 relative to debt. “FFO/interest”, or funds from operations as a multiple of interest
13 owed indicates how well cash flow covers interest expense, and how much money
14 will be left over for unexpected event. Pre-tax interest coverage is a calculation
15 made from audited financial statements that indicates, from an accounting
16 perspective, how well net income, before interest and taxes, covers interest.

17 While it is a metric based on accounting, and not necessarily indicative of the
18 cash available to pay fixed obligations, it is used widely as an indication of how
19 healthy a company’s business is relative to its requirements to pay interest on debt
20 in a timely manner.

21 And finally, “NCF/CAPEX”, or net cash flow as a percentage of capital
22 expenditures, indicates whether a company will have to borrow to complete its
23 capital expenditures program, or be able to fund it internally. Obviously, being

1 able to fund it internally indicates a more creditworthy company. Because an
2 electric utility has large, long lead time capital expenditures, this issue becomes
3 extremely important. The longer a company is exposed to the risks of
4 construction, the more financial risk they take since circumstances change over
5 time, and simply, the more time there is, the more that can go wrong. In Morgan
6 Stanley's Energy Insights of December 3, 2003, in which Judith Warwick, Senior
7 Advisor, discusses the problems facing the next generation of utility CEOs, she
8 discusses the circumstances of the last decade where regulation has been
9 "relatively benign"⁵. Regulated electric companies have not been in a
10 construction mode, electricity prices have stayed fairly constant or declined owing
11 to efficiencies, and few companies have engaged in general rate case activities.
12 Ms. Warwick says "The next generation will face political and regulatory risk and
13 higher credit risk. Indeed, the downgrades for higher capital expenditures have
14 already started. Regulators aren't likely to allow full price recovery or
15 sufficiently high returns. Capital will not be attracted to an industry where returns
16 are insufficient."²

17 **Q. IS THERE A RELATIONSHIP BETWEEN BUSINESS RISK AND**
18 **FINANCIAL RISK?**

19 A. Business risk and financial risk intersect. The higher the business risk, the better
20 the financial performance must be to achieve the same rating. S&P has guidelines
21 which indicate what financial metrics a company needs to achieve to be assigned

⁵ The Next Generation: What Will It Take?, Energy Insights, Morgan Stanly, December 3, 2003

1 a particular rating. As the business risk grows, the financial metrics need to be
2 stronger. The chart appears as SDA-1.

3 In the case of a company with a business risk “5”, such as other Missouri based
4 vertically integrated regulated utilities like Empire District and Ameren, four
5 important financial metrics and the ranges assigned by S&P in order to achieve a
6 minimum investment grade rating (BBB) are as follows:

7 FFO/Total Debt 20.5% to 27%

8 FFO Interest Coverage 3.0x to 4.0x

9 Pre-tax Interest Coverage 2.4x to 3.5x

10 Total Debt to Total Capital 47% to 55%

11 Net cash flow to CAPEX is not a published guideline, but the average for the
12 BBB category for the last three years is 97% according to S&P.

13 **Q. HOW DOES THIS RELATE TO THE RECOMMENDATION OF THE**
14 **STAFF AND PUBLIC COUNSEL?**

15 A. The Staff and Public Counsel recommendations for MPS [REDACTED] will result in
16 financial metrics that are far inferior to those needed to achieve a BBB rating.

17 Indeed, they indicate a B rating, which, as mentioned above, seriously decreases
18 access to capital and increases the cost of funds if they can be obtained. My

19 calculations show that if the operations of MPS [REDACTED] perform on a standalone
20 basis exactly at the Staff’s recommended levels of revenue, expense and net

21 income, they will only be allowed to produce credit metrics consistent with
22 companies rated two notches BELOW investment grade. This is in direct

23 contrast with Staff witness Murray, who states on page 32 of his direct testimony,

1 that his computed level of pretax interest coverage leaves the credit level of these
 2 operations at “between the lower quartile and median quartile for a BBB rated
 3 electric utility.” Mr. Murray uses only one of several credit metrics and ignores
 4 the level of “business risk” used by Standard & Poor’s to make their
 5 determinations. While S&P publishes only four credit metrics, they in fact use
 6 between 7 and 10 when doing a full financial analysis. Likewise, Moody’s
 7 Investors Service uses just as many even though they don’t have a published list
 8 of guidelines.

9 These calculations are presented in exhibit SDA-2 and indicate that the following
 10 metrics will be achieved. I have included the guidelines for business risk “5”, BB
 11 and B rated credits per S&P for comparison.

12	<u>Metric</u>	<u>Staff Recommendation</u>	<u>BB</u>	<u>B</u>
13		<u>MPS</u>		
14	FFO/Debt	14%	15%-20.5%	7.5%-15%
15	FFO/Interest	1.81x	2.1x-3.0x	1.1x-2.1x
16	Pre-Tax Interest	2.06x	1.5x-2.4x	.6x-1.5x
17	Debt to Cap.	64.7%	55.0%-62.5%	62.5%-71%

18 It is obvious that the results of this Staff recommendation will fall far short of
 19 those needed to establish an investment grade rating, and indeed, are more
 20 applicable to a B rated company. Please note that the next rating category below
 21 B is “CCC” for S&P or “Caa” for Moody’s. “CCC” is defined by S&P as “an
 22 obligation....currently vulnerable to nonpayment and is dependent on favorable
 23 business, financial and economic conditions for the obligor to meet its financial
 24 commitment...” Similarly, Moody’s defines an obligation rated “Caa” as one that

1 is “judged to be of poor standing and...subject to very high credit risk.” B ratings
2 are defined slightly less ominously, but carry the distinction of being descriptive
3 of companies for which everything must go right in order to meet its obligations
4 in a timely manner. “Everything” never goes right, even for the healthiest
5 company.

6 **Q. HOW IS REGULATION FACTORED INTO A RATING OR CREDIT**
7 **ANALYSIS?**

8 A. One of the primary issues investors and rating agencies who follow the regulated
9 electric utility sector are concerned about is the regulatory activity to which a
10 company is subject. If it is viewed as punitive because of low allowed rates of
11 return, or rates of return that can’t actually be earned because of rate design,
12 rating agencies will rate companies lower, and those investors who are still
13 allowed to invest in those names will require higher interest rates. Just as ratings
14 are relative, judgments about regulatory jurisdictions are relative. Regulatory
15 Research Associates is a firm headquartered in Jersey City, New Jersey that
16 reports on and evaluates regulatory activities across the country. Investors and
17 rating agencies depend on RRA’s research to provide insight into the nature of the
18 regulatory environment in which companies operate. RRA categorizes regulatory
19 bodies as “above average”, “average”, and “below average”, and gradates those
20 categories further with 1, 2 and 3, with 1 being the best. Please see exhibit SDA-
21 3 for an illustrative example of the ranking scale. Issues like allowed return on
22 equity, rate design, length of time to resolve a case, test year, adjustment clauses
23 and political proclivities of commissioners are evaluated in order to rank each

1 commission. No commission is currently ranked “above average, 1”. Missouri is
2 ranked “average, 3” within the universe of U.S. regulatory jurisdictions. Only
3 five other state regulatory bodies are rated lower. RRA views Missouri regulation
4 as being “restrictive” and equity returns “modestly below industry averages.”⁶

5 **Q. PLEASE DISCUSS DECISIONS OF OTHER “AVERAGE 3”**
6 **COMMISSIONS.**

7 A. Other recent returns on equity decisions have included a 10.79% return on
8 47.04% equity for PacifiCorp in Utah, also ranked “average, 3” by RRA. On
9 December 17, 2003, Connecticut, another “average, 3” jurisdiction allowed
10 Connecticut Light and Power, a distribution company with less business risk than
11 MPS or SJL&P a 9.85% return on 47.22% equity. Montana Dakota Utilities was
12 allowed an 11.5% return on 50.32% equity by North Dakota. North Dakota is
13 also an “average, 3” ranked jurisdiction. Any decisions rendered in Missouri are
14 going to be compared to other jurisdictions as well as examined as to their effects
15 on the companies. Unfavorable rate decisions can, and have, resulted in lower
16 ratings. AmerenUE, as cited later in this testimony, is a recent case in point.

17 **Q. ARE THERE OTHER EXAMPLES OF RATING REDUCTIONS WITH**
18 **WHICH YOU ARE FAMILIAR?**

19 A. Yes. An extreme example of rating reductions resulting from regulatory activity is
20 the case of Nevada Power Company and Sierra Pacific Power Company. They
21 had large deferred energy balances in their balancing accounts as a result of the
22 energy crisis in the Western U.S. in 2000-2001. In March of 2002, Moody’s
23 changed its outlook for both companies to reflect the potential negative

⁶ Missouri State Regulatory Review – May 2003, Regulatory Research Associates

1 consequences of less than adequate recovery of those balances. In April, 2002,
2 Moody's downgraded both companies, and their Parent holding company Sierra
3 Pacific Resources as a result of a ruling in Nevada Power's case that disallowed
4 \$437 million of the \$922 million requested. The Parent's rating fell from Baa3 to
5 Ba2 (non-investment grade), Nevada Power's from Baa1 to Baa3, and Sierra
6 Pacific Power's from A3 to Baa2.

7 **Q. WHAT DOES THIS CASE SHOW?**

8 A. This case is a dramatic illustration of what happens when a utility commission
9 renders a harsh decision that is seen as detrimental to a company's financial
10 stability. Moody's further downgraded all three companies on April 24, 2002 to
11 reflect concerns about the ability of the utility companies to continue to do
12 business with their suppliers. Moody's explained their concern about this issue
13 by stating that "in the absence of cooperation from suppliers by continuing to
14 delay collateral calls and to perhaps renegotiate pricing and other terms of
15 existing contracts, NPC would need to access the capital markets this summer in
16 order to ensure meeting its supply obligations...Given the pressure on the
17 company's credit quality, the ability to obtain sufficient access to the capital
18 markets is uncertain at this time."⁷ Referencing the definition of
19 creditworthiness, it is important to remember that a creditworthy company does
20 not rely on the capital markets to provide cash to pay its obligations.

21 **Q. ARE YOU FAMILIAR WITH ANY REPORTS THAT PERTAIN TO**
22 **MISSOURI REGULATION?**

⁷ Moody's Investors Service press release dated April 24, 2002.

1 A. Yes. Specific to regulation in Missouri is a report published by Moody's
2 in November, 2002 on regulation in states that have yet to implement open
3 access. In the introduction, the report states that "common threads in the
4 supportive jurisdictions include....automatic or annual adjustment clauses
5 for recovery of changes in fuel and energy costsand reasonable
6 authorized return on equity levels."⁸ In its assessment of regulation in
7 Missouri, Moody's wrote "we have typically expressed more concerns
8 about utility regulation in Missouri as compared to many other states.
9 Among these concerns have been the tough positions often taken by the
10 Missouri PSC with respect to the utilities' efforts to raise rates to recover
11 higher costs of service...Indeed, there have been occasions where rate
12 reductions were the end result of rate filings....In the case of Kansas City
13 Power & Light, its ratings ...incorporate recently implemented rate
14 reductions in its Missouri....jurisdiction...As of AmerenUE, we note that
15 its negative rating outlook is partly reflective of the challenges it faces to
16 meet expected higher capital spending, while implementing recently
17 imposed rate cuts....Empire District's rating outlook remains negative
18 today, reflecting in part the need for regulatory support....to stabilize the
19 rating outlook."⁹

⁸ A Look at How Regulators Support U.S. Electric Utilities in States That Have Yet to Restructure,
Moody's Investors Service, November 2002

⁹ A Look at How Regulators Support U.S. Electric Utilities in States That Have Yet to Restructure,
Moody's Investors Service, November 2002

1 In February of 2003, Moody's lowered AmerenUE's ratings "because of lower
2 revenues resulting from a rate settlement reached last year with the Missouri
3 Public Service Commission".¹⁰ In December of 2003, Moody's update on Aquila
4 itself gives the company a negative outlook, and states that "Future projected
5 revenues and cash flow of its utilities are contingent upon favorable regulatory
6 decisions regarding its pending rate cases."¹¹

7 **Q. WHAT IS YOUR CONCLUSION ABOUT THE STAFF AND PUBLIC**
8 **COUNSEL RECOMMENDATIONS?**

9 A. It is clear that the recommendations will result in very poor financial metrics for
10 both MPS [REDACTED]. The resulting financial profile is barely adequate for a B
11 rating. The consequences of such poor creditworthiness for these two regulated
12 vertically integrated utilities, which are part of the core assets of Aquila and
13 operate in the business to which Aquila is trying to return are far reaching. The
14 more optimistic investor opinion indicated by improving prices for Aquila and
15 UtiliCorp bonds since roughly April of 2003, when some progress was being seen
16 on Aquila's restructuring plan, will reverse. Investors are looking for Aquila to
17 perform on its stated goal to revert to its roots, and have paid higher prices for the

¹⁰ Global Credit Research Rating Action, Moody's Investors Service, February 10, 2003

¹¹ Global Credit Research Opinion Update, Moody's Investors Service, December 10, 2003

1 bonds since multiple non regulated asset sales have be accomplished. If the core
2 businesses of the Company, which is what investors believe they are investing in,
3 are to be subjected to punitive regulatory treatment, investors opinions will revert
4 to the previous skeptical mode, making money much more expensive for Aquila
5 to attain. In the long run, ratepayers pay for that higher cost of debt.

6 A more direct and immediate impact on ratepayers is the quality of the service
7 they receive. The entire electric industry has an aging infrastructure, and MPS
8 [REDACTED] are no exceptions. If service is to be kept at a reasonable level,
9 depreciation allowed in rates must be relative to needed capital expenditures to
10 maintain the system. Cutting depreciation rates so as to keep rates down does a
11 disservice to customers who have become used to high quality electric service. It
12 is only reasonable, then, that utilities be allowed depreciation rates that will allow
13 them to maintain their systems in good working order.

14 **Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.**

15 A. The foregoing is an attempt to focus the Commission on the realities of how the
16 investing community, without whom high capital intensive companies cannot
17 exist, will react to a rate decision that essentially results in “B” quality companies.
18 The electric utility industry has always been a popular investment for investors
19 looking for decent returns in a relatively stable environment. Adopting the Staff’s
20 or Public Counsel’s recommendation will not provide them with anything close to
21 that.

Schedule SDA-1

Standard & Poor's Financial Targets

FFO/Total Debt

Business Position	AA		A		BBB		BB		B	
	1	20.0	16.5	16.5	12.5	12.5	7.0	<7.0		-
2	25.0	21.0	21.0	16.0	16.0	10.5	<10.5		-	-
3	31.5	26.0	26.0	20.0	20.0	14.0	14.0	9.5	9.5	4.0
4	36.5	30.5	30.5	24.5	24.5	17.5	17.5	12.0	12.0	6.0
5	40.0	33.0	33.9	27.0	27.0	20.5	20.5	15.0	15.0	7.5
6	47.0	39.0	39.0	31.0	31.0	22.0	22.0	16.0	16.0	8.5
7	56.0	47.0	47.0	36.5	36.5	24.5	24.5	17.0	17.0	9.5
8	66.0	55.0	55.0	42.5	42.5	27.5	27.5	18.0	18.0	11.0
9	-	-	64.5	49.5	49.5	32.0	32.0	22.0	22.0	12.5
10	-	-	78.0	60.5	60.5	39.0	39.0	28.0	28.0	17.5

FFO/Interest Coverage

	AA		A		BBB		BB		B	
	1	3.1	2.6	2.6	1.9	1.9	0.9	<0.9		-
2	3.9	3.3	3.3	2.5	2.5	1.5	<1.5		-	-
3	4.5	3.9	3.9	3.1	3.1	2.1	2.1	1.3	1.3	.05
4	5.1	4.5	4.5	3.8	3.8	2.7	2.7	1.8	1.8	.09
5	5.4	4.8	4.8	4.0	4.0	3.0	3.0	2.1	2.1	1.1
6	6.6	5.7	5.7	4.5	4.5	3.1	3.1	2.2	2.2	1.2
7	8.4	7.0	7.0	5.1	5.1	3.3	3.3	2.3	2.3	1.3
8	10.2	8.3	8.3	5.9	5.9	3.5	3.5	2.4	2.4	1.5
9	-	-	9.5	7.1	7.1	4.3	4.3	2.9	2.9	1.8
10	-	-	11.3	8.6	8.6	5.3	5.3	3.6	3.6	2.3

Pre-tax Interest Coverage

	AA		A		BBB		BB		B	
	1	2.8	2.4	2.4	1.8	1.8	0.8	<0.8		-
2	3.4	2.9	2.9	2.3	2.3	1.3	<1.3		-	-
3	4.0	3.4	3.4	2.8	2.8	1.8	1.8	1.1	1.1	0.3
4	4.6	4.0	4.0	3.3	3.3	2.2	2.2	1.3	1.3	0.5
5	5.0	4.3	4.3	3.5	3.5	2.4	2.4	1.5	1.5	0.6
6	6.2	5.2	5.2	4.0	4.9	2.6	2.6	1.6	1.6	0.7
7	8.0	6.5	6.5	4.7	4.7	2.8	2.8	1.8	1.8	0.9
8	9.9	8.0	8.0	5.5	5.5	3.0	3.0	2.0	2.0	1.1
9	-	-	9.1	6.6	6.6	3.7	3.7	2.5	2.5	1.4
10	-	-	11.1	8.4	8.4	5.0	5.0	3.3	3.3	1.8

Total Debt/Total Capital											
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	AA		A		BBB		BB		B	
1	50.5	55.0	55.0	60.5	60.5	67.5	>67.5	-	-	-
2	46.5	51.0	51.9	56.5	56.5	63.5	>63.5	-	-	-
3	42.0	47.5	47.5	53.0	53.0	61.0	67.0	67.0	74.0	74.0
4	37.5	43.0	43.0	49.5	49.5	57.0	57.0	64.0	64.0	72.5
5	36.0	41.5	41.5	47.0	47.0	55.0	55.0	62.5	62.5	71.0
6	32.5	39.5	39.5	46.0	46.0	53.5	53.5	60.5	60.5	69.0
7	30.5	37.5	37.5	45.0	45.0	52.5	52.5	59.5	59.5	68.0
8	28.0	35.0	35.0	43.0	43.0	51.5	51.5	58.0	58.0	66.0
9	-	-	30.0	39.0	39.0	47.5	47.5	54.0	54.0	61.5
10	-	-	24.0	33.0	33.0	40.5	40.5	46.0	46.0	53.0

Pretax Interest Coverage

	MPS
Net Income	\$ 21.1
Income Taxes	13.1
Interest Expense	<u>32.3</u>
Pre-tax income	\$ 66.5
Interest Expense	32.3
Pre-tax Interest Coverage	2.06x

S&P Guidelines for Business Risk "5"

BBB	3.5x-2.4x
BB	2.4x-1.5x
B	1.5x-0.6x

Conclusion: MPS qualify for a BB rating on this metric

Total Debt/Total Capitalization

Total Debt/Total Capitalization	64.7%
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S&P Guidelines for Business Risk "5"

BBB	47.0%-55%
BB	55.0%-62.5%
B	62.5%-71.0%

Conclusion: MPS [REDACTED] qualify for a B rating on this metric

ⁱ According to Staff Assumptions

- Rate base equals \$654,000,000 for MPS
- Midpoint allowed ROE of 9.14% with cost of debt 7.63%
- Equity as percent of total capital equals 35.3%
- Income tax rate of 38.4% with deferred taxes for MPS of \$2.6 million
- Amortization and depreciation is \$34.7 million for MPS
- Business risk assumed as "average" or "5" out of "10" on S&P's scale

Schedule SDA-3
RRA Grading System

Above Average	Average	Below Average
1	1	1
None	11 States	5 States
2	2	2
5 States	10 States	None
3	3	3
2 States	16 States	None

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of Aquila, Inc. d/b/a Aquila)
Networks-MPS [REDACTED])
for authority to file tariffs increasing electric)
rates for the service provided to customers in)
the Aquila Networks-MPS [REDACTED])
[REDACTED] area)

Case No. ER-2004-0034

[REDACTED])
[REDACTED])
[REDACTED])
[REDACTED])

[REDACTED]

County of Jackson)
) ss
State of Missouri)

AFFIDAVIT OF SUSAN ABBOTT

Susan Abbott, being first duly sworn, deposes and says that she is the witness who sponsors the accompanying testimony entitled "Rebuttal Testimony of Susan Abbott;" that said testimony was prepared by her and under her direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, she would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of her knowledge, information, and belief.

[Signature]
Susan Abbott

Subscribed and sworn to before me this 26th day of January, 2004.

[Signature]
Notary Public
Terry D. Lutes

My Commission expires:
8-20-2004

