MISSOURI PUBLIC SERVICE COMMISSION'S

STAFF REPORT ON

AQUILA, INC.

DECEMBER 2002

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Section 1: Overview-Executive Summary

The Missouri Public Service Commission directed its Staff to review and report on the evolving financial situation at Aquila, Inc. and the implications that situation has on Aquila's regulated operations in Missouri. Aquila's Missouri regulated operations consist of separate service areas for electric and natural gas service certificated to Aquila, Inc. d/b/a Aquila Networks-MPS (MPS, formerly UtiliCorp United Inc. d/b/a Missouri Public Service), Aquila, Inc. d/b/a Aquila Networks-L&P (L&P, formerly UtiliCorp United Inc. d/b/a St. Joseph Light & Power) and steam heating service certificated under L&P. MPS and L&P are divisions of Aquila. Aquila acquired L&P through a $282 million merger at the end of 2000.

The Staff was to prepare a report of the information relevant to the Commission's inquiry. The report was to be submitted to the Commission by the beginning of December 2002. There is no discussion of any open case included in this report. Any issues regarding Aquila's financial condition relevant to those cases will be addressed in each of the specific cases. This includes any open Purchase Gas Adjustment (PGA) and Actual Cost Adjustment (ACA) case.

Following Enron's collapse last year, many energy companies have suffered from falling power prices, decreased trading activity and lowered investor confidence, as well as an industry-wide credit squeeze. This situation has had a significantly negative impact on Aquila's financial condition, forcing it to sell assets, cut costs and seek other means to raise cash. Aquila's deteriorating financial condition has created a significant and growing level of concern regarding the ultimate impact of this situation on Aquila's Missouri regulated utility operations. This concern increases over time as Aquila's financial condition fails to stabilize and continues to be challenged. The consequences to Missouri's regulated operations resulting from all these changes are becoming an issue to a growing number of people. All of these changes are increasingly important to consumers served by Aquila, the investment community and the Missouri Public Service Commission. In its work during the past several weeks, the Staff has been seeking information to gain a greater and more detailed understanding of Aquila's current financial position, its provision of customer service and its future ability to provide safe and reliable service at just and reasonable rates. The Staff does not know the ultimate impact of Aquila's financial troubles, but will address, in this report, the options the Commission has available to it to effectively handle any potential negative impacts that Aquila's financial troubles may have on its Missouri operations.

History has shown that no one has publicly been able to predict the next change to Aquila's financial condition. The Staff unfortunately cannot put an end to the speculation and opinion that is certain to continue to evolve with any new negative information regarding Aquila's financial condition. While it is not the Staff's intent through this report to add to the level of speculation and opinions regarding Aquila's ultimate financial outcome, Staff must still proceed with its investigation and has done so.

Staff has initiated the process of monitoring, identifying, evaluating and documenting potential negative implications from the deterioration of Aquila's financial condition. This report provides the results of Staff's review and examination of Aquila's Missouri regulated operations. The Staff will recommend to the Commission enforcement options be exercised whenever suitable arrangements cannot be made with Aquila to address an immediate concern. Staff currently has two Data Requests (DRs) still outstanding, is awaiting updates on two more and needs additional time to review information just recently received from Aquila due to training and other cases. Staff will do a supplement to this report as circumstances warrant or as directed by the Commission.

Section 2: Background

A. Aquila Before the Enron Collapse

This section provides background material regarding the entity now called Aquila.

Aquila's Corporate Structure and Operations

Aquila was founded in 1917 as Green Light and Power Company. This operation grew into the provision of electric, natural gas and water regulated services in Missouri. ~~Aquila~~ changed its name to the Missouri Public Service Company (MPS) in 1927, to UtiliCorp United, Inc. in 1985 and finally to Aquila in 2002. Aquila maintains its headquarters at 20 West 9th Street in Kansas City, Missouri.

Between 1985 and 2002, Aquila grew from a medium-sized electric utility to an international energy and risk management company into one of the largest wholesalers of electricity and natural gas in North America. By 2002, Aquila owned and operated electrical and natural gas distribution networks in seven states of the United States of America as well as distribution networks in Canada, New Zealand and Australia. As of December 31, 2001, Aquila had total assets of $12 billion and annual sales of $40 billion. The chart below shows the growth in Aquila's assets and sales over the past eleven years.

	Assets	Sales
1991	$2,400,000,000	$1,700,000,000
1992	$2,500,000,000	$2,300,000,000
1993	$2,800,000,000	$2,700,000,000
1994	$3,100,000,000	$2,400,000,000
1995	$3,900,000,000	$2,800,000,000
1996	$4,700,000,000	$4,300,000,000
1997	$5,100,000,000	$8,900,000,000
1998	$6,100,000,000	$12,500,000,000
1999	$7,500,000,000	$18,600,000,000
2000	$14,100,000,000	$29,000,000,000
2001	$12,000,000,000	$40,000,000,000

In 2001, Aquila was organized and managed as four business segments. These business segments were: 1) Energy Merchant, 2) U.S. Networks, 3) International Networks, and 4) Services. In November 2001, Aquila combined its U.S. Networks segment and its International Networks segment into the Global Networks business segment.

Energy Merchant Business Segment

Aquila's Energy Merchant business segment provided risk management products and services, traded energy-related and other commodities, and marketed natural gas and electricity to industrial and wholesale customers in the United States and Canada. Merchant Services also marketed energy in Europe through its offices in the United Kingdom, Germany and Norway. In 2001, Aquila's merchant services business had $37.7 billion in sales, which accounted for 94% of Aquila's total sales, and contributed 65% of Aquila's earnings before interest and taxes (EBIT). At December 31, 2001, Merchant Services had $6.2 billion in assets, or 52% of Aquila's total assets. The energy-trading component of Merchant Services (the business recently exited by Aquila) alone accounted for 90% of total company revenue, which made it one of the top trading companies in the United States.

U.S. Networks Business Segment

As a component of its Global Networks Group, Aquila's U.S. Networks' operating divisions in the U.S. serves approximately 349,000 electric distribution customers in three states: Missouri, Kansas and Colorado; and 831,000 natural gas distribution customers in seven states: Missouri, Kansas, Colorado, Nebraska, Iowa, Michigan and Minnesota. Its seven domestic utility divisions are Aquila Networks-MPS, Aquila Networks-L&P, Kansas Public Service, Peoples Natural Gas, WestPlains Energy, Northern Minnesota Utilities and Michigan Gas Utilities.

In 2001, U.S. Networks had approximately $2.3 billion in sales, which accounted for 5.6% of total company sales, and contributed 16.7% of total company EBIT. At December 31, 2001, U.S. Networks had $3.5 billion in assets, or 29.4% of total company assets.

International Networks Business Segment

The second component of Aquila's Global Networks Group, Aquila's International Networks operated electric and gas utility networks in Australia, New Zealand and Canada. Aquila managed and was 34% owner of United Energy in the Australian State of Victoria. United Energy has four business units: Distribution, Energy Merchant, Utili-Mode and UeComm. The Distribution unit serves 1.1 million electricity and gas customers in Melbourne and the Mornington Peninsula. UeComm, a telecommunications business, has developed networks in Sydney, Melbourne and Brisbane. Utili-Mode offers energy-related "back office" services including call center, billing, metering and account collection functions. The Energy Merchant business buys and sells electricity in the wholesale market, trades related commodities, and sells risk management products.

Aquila and United Energy jointly own 45% of AlintaGas Limited, a natural gas distributor in the state of Western Australia. AlintaGas is based in the city of Perth and has more than 430,000 customers.

Aquila owned 55% of UnitedNetworks Limited (UnitedNetworks), a company that serves approximately 600,000 customers, mostly in the Auckland and Wellington areas. UnitedNetworks is one of New Zealand's largest network infrastructure companies, distributing energy to about 30% of the country's electricity consumers and more than half of New Zealand's natural gas consumers. It also owns and manages a telecommunications networks business. Aquila created UnitedNetworks in 1998 by combining the electrical distribution operations it acquired from three different New Zealand utilities, and later a natural gas network. On October 11, 2002, Aquila announced the sale of UnitedNetworks with its share of the proceeds estimated to be approximately $362 million.

Aquila has been operating in Canada since its acquisition of West Kootenay Power in 1987. In February 2000, Aquila acquired TransAlta Corporation's distribution and retail operations in Alberta for $480 million. Aquila operates this business as Aquila Networks Canada (Alberta), Ltd.

In 2001, Aquila's International Networks unit had approximately $354 million in sales, which accounted for less than 1% of Aquila's total sales, and contributed 17% of Aquila's EBIT. At December 31, 2001, International Networks had $1.9 billion in assets, or 16% of total Company assets. The major change in Aquila's International Networks business is the sale of its utility operations in New Zealand. On a going-forward basis, Aquila's International Networks business will consist only of its utility businesses in Australia and Canada.

Services Business Segment

In 2001, this segment primarily consisted of Quanta Services and Aquila Communications Services. During 2001, (Aquila held a 38.5% equity interest in Quanta Services, a Houston-based firm that builds and maintains networks carrying energy and telecommunications. In 2001 and the beginning of 2002, Aquila spent considerable time and resources trying, unsuccessfully, to achieve control over Quanta's operations.

Formed in early 2000, Aquila Communication Services provided a range of broadband services including local and long-distance voice, high-speed Internet access and digital television. Aquila's current efforts are concentrated in the Midwest region in partnership with Unite, a competitive local exchange carrier serving an area north of Kansas City, and Everest Connections Corporation, a St. Louis-based telecommunications company involved in the construction and operation of broadband fiber-optic networks to homes and businesses. During 2001, Aquila decided to limit its fiber-optic communications business to the Kansas City market. As a result, it wrote off $16.5 million related to network design, long-term leases and other development costs related to markets outside of Kansas City that it does not intend to develop.

B. Aquila Following the Collapse of Enron

The financial collapse of Enron saw the beginning of significant impacts on the utility industry and, specifically, certain electric companies. Aquila was a company that was significantly impacted following Enron's financial demise. Enron formalized its financial collapse by filing for bankruptcy on December 2, 2001. The impacts upon Aquila of the Enron financial collapse can be illustrated by the change in Aquila's debt credit ratings.

There are three credit rating agencies that rate the quality of the debt issued by various entities, including utilities. These credit rating agencies are Standard and Poor's, Moody's and

FitchRatings. At that time of the Enron bankruptcy filing, Aquila (now Aquila) had the following credit ratings:

Fitch	BBB, Negative Watch
Standard and Poor's	BBB, Stable Outlook
Moody's	Baa3, Stable Outlook

Credit rating agencies established higher financial thresholds for investment-grade companies after Enron's collapse. Aquila determined that under the new market conditions and more stringent requirements recently established by credit rating agencies, it did not have sufficient liquidity to continue in the trading business in its Energy Merchant Business segment. Aquila indicated that by some estimates it would require $2.5 billion in cash or readily available marketable securities in order to continue its trading operations.

Aquila has indicated that the rating agencies began expressing concern regarding its credit rating early in 2002. On February 27, 2002, FitchRatings downgraded Aquila credit rating to BBB- with a stable outlook. The rating downgrade was cited as due primarily to Aquila's increasing dependence upon cash flows derived from its merchant energy business. (Aquila Merchant Services, Inc.) This downgrade took into consideration the merchant energy business' reliance on the parent company for funding and the merchant energy business' need for funds to support its ongoing internal growth and high capital expenditures related to merchant generation and gas storage.

Aquila's financial problems attracted greater public notice with the announcement in April 2002 by Moody's Investors Services that it was changing Aquila's outlook to negative. In response to this action, Aquila issued a press release on April 29, 2002, describing its current focus on its balance sheet and investment grade rating. In this press release, Aquila stated that it had taken a number of positive steps over the past 12 months to strengthen its balance sheet and liquidity position. Aquila announced that it has issued over $1 billion in equity, planned to sell $500 million in less strategic assets, and was implementing cost-cutting and revenue-enhancement measures with a goal of increasing earnings by $100 million. This initiative became known as Project BBB+/Baa1. This effort was intended to establish Aquila with an investment grade debt rating from both Standard and Poor's and Moody's.

In addition to these actions, Aquila responded by reducing costs approximately $100 million, exiting the energy trading business, lowering its common stock dividend by 42%, issuing $800 million of equity and debt to improve liquidity, establishing new revolving credit lines, canceling the announced purchase of Cogentrix and selling assets as part of a $1 billion divestiture program. Aquila initiated these actions to improve its credit rating and to strengthen its balance sheet, and to meet Moody's and Standard and Poor's credit metrics requirements. Aquila referred to this effort as part of its "Project BBB+/Baa1."

On May 21, 2002, Moody's Investors Services placed Aquila under review for possible downgrade. In a press release issued on that date, Robert K. Green, Aquila's then President and Chief Executive Officer stated, "We've maintained an open dialogue with Moody's and made them aware of our plans to improve cash flow. We've already identified approximately $96 million in savings as a result of staff reductions, elimination of executive incentives and a tightening on all expenditures. We expect to make significant progress in short order."

The next day, May 22, 2002, Aquila announced that it was eliminating approximately 200 positions from its Merchant Services and Corporate staffs. This staff reduction was in addition to the elimination of 500 positions upon completion of the previously announced restructuring of its Networks business.

On June 17, 2002, Aquila announced a new three-part plan including: (1) a significant reduction and downsizing of its wholesale energy services business in response to the increased cost of capital for that business; (2) an anticipated $.50 per share reduction in the annual common dividend to a new rate of $.70 per share; and (3) the issuance of $900 million of new equity and debt securities in order to balance the capital structure and satisfy Aquila's remaining 2002 liquidity needs, including the funding of previously announced acquisitions.

On August 5, 2002, Standard and Poor's reaffirmed Aquila's credit rating of BBB with CreditWatch Negative, following cancellation of the proposed acquisition of Cogentrix Energy, Inc. Standard and Poor's cited the cancellation as positive for the credit quality of Aquila, but it would not immediately affect the current rating or outlook for Aquila. Aquila had been placed on CreditWatch with negative implications when the Cogentrix transaction was announced.

On August 6, 2002, less than a month after it announced that it would restructure the wholesale energy marketing and trading business of its Merchant Services segment, Aquila announced that it was totally eliminating all wholesale energy marketing and trading.

On August 16, 2002, Aquila released information outlining initiatives taken in the past six months that had favorable implications for its risk profile, cash flows and credit ratings. These actions included:

- Terminating the Cogentrix acquisition
- Reducing its dividend by 42%
- Exiting from the wholesale energy trading business
- Completing equity and debt offerings totaling $764 million in proceeds
- Identifying over $100 million in cost reductions
- Targeting over $1 billion in asset sales

On August 19, 2002, FitchRatings revised Aquila's Rating Outlook to Negative from Stable based on its ongoing review of Aquila's liquidity and financial flexibility at a time when Aquila was shedding business lines and assets.

On September 3, 2002, Moody's downgraded Aquila to Ba2 with a Stable outlook. According to Aquila, Moody's cited execution risk on the asset divestiture program as a major concern. Earlier in the year, Moody's had threatened to downgrade Aquila's credit rating due to its deteriorating financial situation. Moody's rating of Ba2 is considered non-investment grade or "junk." Moody's downgrade meant that Aquila had to pay $192 million in obligations within 60 days to cover financial triggers tied to its credit ratings.

On September 4, 2002, Standard and Poor's downgraded Aquila's credit rating to BBB- with Outlook Negative. According to Aquila, Standard and Poor's acknowledged execution risk related to the asset divestiture program but was willing to give management more time to implement its plan. Standard and Poor's action confirmed Aquila's investment grade credit rating and removed Aquila from credit watch. This action by Standard and Poor's moved Aquila's credit rating to BBB- from BBB and placed Aquila on negative outlook. As a part of its credit assessment, Standard and Poor's stated that to maintain credit quality in the triple-B range, Aquila must complete asset sales, further reduce business risk and improve utility operations.

On October 1, 2002, Aquila's President and Chief Executive Officer Robert Green resigned from all executive officer positions with Aquila and from its board of directors. Robert Green's separation package had a value of approximately $7.6 million. The board reassigned Robert Green's CEO responsibilities to longtime Chairman Richard C. Green, Jr.

On October 16, 2002, Aquila reported additional asset sales under its previously announced restructuring program, bringing the current total of assets it has sold or agreed to sell to $976.6 million. Aquila's stated goal is to sell at least $1 billion in assets to strengthen its balance sheet and credit. Aquila's Chairman, President and Chief Executive Officer Richard C. Green, Jr. stated that: "We are continuing to focus on our transition back to our roots as a regulated utility company and our exit from the elements of our previous energy merchant strategy that are not consistent with our current business model."

In early November 2002, Aquila announced it had wrapped up the first phase of bidding for sale of Midlands. They expect the next phase, binding offers, to be completed in November. Aquila stated that Midlands is the last asset it will have for sale and that it would not sell it at a loss or have a "fire sale." Aquila also stated it did not need the sale of Midlands to meet its goal of selling $1 billion in assets.

On November 13, 2002, as part of its ongoing transition plan, Aquila announced that its board of directors has suspended the quarterly cash dividend on Aquila common stock for an undetermined period. The board reached this decision after the new management team completed a detailed analysis of Aquila's current financial condition. Suspension of the dividend is part of Aquila's strategy to achieve its goal of strengthening its credit profile. In the press release, Richard C. Green, Jr., stated that Aquila plans to do more than simply survive, and that "Aquila's liquidity is sufficient to ensure that Aquila can continue to operate safe and reliable utility networks and maintain quality customer service. This remains a healthy core business."

Also on November 13, 2002, Aquila reported a Third Quarter loss. Aquila also announced that as a result of its operating performance, the winding down of merchant energy businesses and the asset sales program, that it does not expect to be in compliance with an interest coverage requirement contained in certain financial arrangements until December 31, 2003. According to Aquila's 10Q filing with the Securities and Exchange Commission, as of September 2002, Aquila's revolving credit agreement is the only obligation on its balance sheet that contains these interest coverage ratio provisions.

Aquila has obtained a waiver from this requirement that will expire on April 12, 2003. Aquila has agreed to make certain payments to the financial institutions, to limit its dividends, to have lower borrowing capacity under its revolving credit agreements, and to use reasonable efforts to obtain approvals from regulators that would allow it to pledge its domestic regulated assets as collateral. Aquila agreed to renegotiate its bank financing arrangements prior to the waiver's expiration. In Aquila's September 30, 2002, 10Q filing Aquila noted that, because of the downgrade in its credit rating to Ba2 by Moody's, the interest rate on $500 million of senior notes due 2012 increased from 11.875% to 13.125% and the interest rate on $250 million senior notes due 2011 increased from 7.95% to 8.70%.

On November 13, 2002, the prior ratings actions had resulted in the following credit ratings for Aquila:

- Fitch — BBB-, Negative Watch
- Standard and Poor's — BBB-, Negative Outlook
- Moody's — Ba2, Stable Outlook

Both Fitch's and Standard and Poor's ratings were still considered investment grade. Aquila expected no additional ratings actions from either Standard and Poor's or Moody's until early 2003, when Aquila completes its asset divestiture program and finalizes its 2002 financial results.

Aquila asserted that its lowered credit ratings were not unique, stating that Moody's currently rates over 20 U.S. utilities as sub-investment grade and those utilities are continuing to provide safe and reliable service. Lower credit ratings can impact a company's cost of capital, and Aquila admits that its marginal cost of capital has increased. Deterioration of credit quality for diversified energy companies and events, such as the Enron collapse, has made access to capital markets more difficult. It has also made what access is available more expensive.

As an example, Aquila sold unsecured notes with a 30-year maturity at a coupon rate of 7.875% as of March 2002. As of July 2002, it sold notes with a 10-year maturity at a coupon rate of 11.875%. In a normal interest rate environment, shorter-term notes pay a lower coupon than longer-term notes. The longer-term notes typically require a higher coupon to compensate the note purchaser for interest rate risk (the risk of interest rates rising while an investor is locked in long-term at lower rates). In Aquila's case, its short-term rates were higher than its long-term rates just three months prior.

Aquila claims that the impact of higher capital costs is mitigated by the fact that it does not expect to be a "net borrower" over the coming months. Aquila asserts that it intends to use the proceeds from the $1 billion divestiture program to reduce debt and have targeted repurchase of the 11.875% notes (now 13.125%) given their higher interest rate.

Additional credit rating actions took place in 2002. On November 15, 2002, Fitch announced the downgrade of Aquila's senior unsecured rating to BB from BBB- and placed Aquila on Rating Watch Negative. This action was taken pending a comprehensive review of the outlook for the remaining core business and the refinancing of credit facilities now set to come due on April 12, 2003. Subsequent to the downgrade, Aquila announced that with liquidity at close to $900 million, it is prepared to respond to the potential effects resulting from the downgrade.

On November 19, 2002, Standard and Poor's downgraded Aquila to BB from BBB-. The outlook remains negative. The downgrade reflects the slower-than-expected recovery of its credit quality as Aquila exits the merchant energy business and recent financial results that revealed lower than anticipated operating cash flows and higher debt leverage numbers. Standard and Poor's stated that the numbers were weaker than expected and that Aquila's financial plan has not provided the level of sustainable cash flow necessary for investment-grade status. Aquila responded to the downgrade with an announcement that its liquidity was sufficient to meet the cash needs resulting from the downgrade without affecting its operations. According to Aquila's September 30, 2002, 10Q, because of the downgrade of the Aquila's credit rating to BB by Standard and Poor's, the interest rate on $500 million of senior notes due 2012 increased from 13.125% to 14.375% and the interest rate on $250 million senior notes due 2011 increased from 8.70% to 9.45%. Aquila stated that the downgrade could potentially trigger approximately $238 million in additional demands for cash.

There were several factors creating demands for cash after the Standard and Poor's downgrade. Aquila stated that $84 million in four series of Australian denominated bonds guaranteed by Aquila have provisions that could require Aquila to repurchase the bonds if the bondholders choose to exercise that option in the next 30 to 60 days. Aquila also has a tolling agreement that could require Aquila to post $37 million in additional collateral within 70 days to eight months of a Standard and Poor's downgrade. Tolling agreements allow Aquila to generate power at plants owned by others in exchange for the natural gas that fuels the plants. Another approximately $23 million would need to be posted to cover standard margining agreements remaining from Aquila's discontinued wholesale energy merchant business. There is also the potential that Aquila may be required to post additional collateral of up to $94 million related to certain commodity contracts.

After the Standard and Poor's announcement, Aquila's credit ratings were as follows:

• Fitch	BB, Negative Watch
• Standard and Poor's	BB, Negative Outlook
• Moody's	Ba2, Stable Outlook

Aquila no longer had an investment grade rating from any rating agency.

Further downgrades by Moody's below Ba3 or by Standard and Poor's below BB-, may require Aquila to post an additional $73 million in collateral. Any downgrade below Moody's current rating of Ba2 results in a .25% increase in interest on both sets of notes previously mentioned. Any downgrade below Standard and Poor's current rating of BB results in a 1.50% increase in interest on the $500 million, 2012 notes, and a 1.00% increase in interest on the $250 million, 2011 notes.

C. Possible Negative Impacts of Recent Financial Activity on Missouri Regulated Operations

The Staff has attempted to identify possible negative impacts of all this activity on the rates charged and the quality of service provided to Aquila's Missouri electric and gas consumers. Subsequent sections will provide possible safeguards or Staff actions to mitigate these concerns. Specific concerns are whether: 1) the higher capital, interest and restructuring costs will lead to higher utility rates; 2) the reduced access to funds will reduce the quality of service; and 3) the employee reductions will produce service and safety issues. Another concern could be identification of future proceedings that require expertise that presently does not reside within the Missouri Public Service Commission and its Staff.

One of the initial steps to protect consumers from the negative cost of service impacts of these actions is to identify and document the specific negative items that can have possible detrimental impacts on Aquila's Missouri operations. At this time, Staff has identified the higher capital and interest costs as possible negative impacts on Aquila's Missouri regulated utility rates. These costs have already been noted as a result of the downgrade of the Aquila's debt ratings below investment-grade status. As a result of the downgrade of Aquila's credit rating by Moody's on September 3, 2002, and by Standard and Poor's on November 19, 2002, the interest rate for $500 million in senior notes for Aquila was increased from 11.875% to 14.375%. The interest rate on an additional $250 million of debt increased from 7.85% to 9.45%. These rates will be increased again if Aquila is further downgraded by Standard and Poor's or Moody's.

Another negative cost of service item is the restructuring costs. The cost to Aquila of the restructuring actions was approximately $188 million for the nine months ended September 30, 2002. These restructuring charges include $54.1 million in severance costs related to the elimination of approximately 1,630 employees (including employees transferred with the sale of businesses). Approximately 1,120 Merchant Service employees, 80 corporate employees and 430 Domestic Networks employees were terminated.

Also included in the $188 million restructuring charges were $28.9 million in employee retention payments, $36.7 million in abandoned lease agreements, $59.2 million in the write-down of leasehold improvements and equipment previously used in the wholesale energy trading business and $7.1 million loss on sale of Aquila's corporate aircraft.

Another possible negative impact is the accounting treatment for losses related to non-regulated property. For example, Aquila has reduced its ownership interest in Quanta Services from a high of 38% to 14% as of October 2002. Quanta's stock price has decreased significantly from Aquila's cost basis of $26.69 to less than $3 per share. This reduction in Quanta's stock price has caused Aquila to write down its investment in Quanta by $698.1 million in the nine months ended September 30, 2002. Aquila expects to dispose of its remaining Quanta shares prior to December 31, 2002.

In its continuing transition from an energy merchant to an integrated utility, Aquila expects to record in the fourth quarter of 2002 significant charges relating to contract renegotiations, the continued exit of wholesale commodity positions, potential losses on sale or impairment of assets and additional severance costs.

The financial effects of Aquila's operating performance, the winding down of its wholesale energy trading business and its asset sales program have caused Aquila to not be in compliance with certain debt agreements with its lenders. The impact of future developments from this condition could result in proceedings before the Commission that are unprecedented and require expertise not readily available to the Agency. These debt agreements require that Aquila's earnings before interest, taxes, depreciation and amortization (EBITDA) during the previous four quarters must be at least 2.25 times its interest expense during this period. This is referred to as an interest coverage ratio. Aquila does not expect to be in compliance with these debt agreements until at least December 31, 2003.

However, Aquila obtained waivers from the affected lenders from the requirement to comply with its interest coverage ratio from September 30, 2002, until April 12, 2003. In exchange for this waiver, Aquila paid down approximately $158.6 million in debt. Aquila further agreed that 50% of any net cash proceeds it receives from the sales of assets under $1 billion and 100% of any net cash proceeds from any further sales of its North American assets above $1 billion dollars received prior to April 12, 2003, would be used to reduce its obligations to these lenders on a pro rata basis. Aquila agreed to make reasonable efforts to obtain approvals from regulators to allow Aquila to use certain of its regulated assets as security for the benefit of its lenders. In addition, Aquila was required to pay fees of approximately $2.4 million to the lenders in connection with these waivers. Should the waiver obtained by Aquila not be extended beyond April 12, 2003, and the affected lenders demand payment in full, substantially all of Aquila's remaining debt would become due and payable. Aquila would not have the liquidity to meet these obligations as they become due and will be in default. Aquila is continuing to work with its lenders to reach an agreement before the expiration of the current waivers.

The changes that have occurred at Aquila over the last year have created conditions that can be detrimental to ~~the operation of Aquila's Missouri~~ regulated properties. The Staff has identified the need to monitor the situation and identify areas that may potentially be or currently are potential problems. This monitoring will include the review of external sources and responses to Data Requests. Negative items will be identified and addressed in the appropriate venue based on the specific facts and circumstances. The details of the specific areas impacting rates, quality of service and safety are provided in the following sections of this report.

Section 3: Rates and Cost of Service Issues

Aquila's last rate case was filed before this Commission in June 2001 and sought an annual increase of $49.4 million. Aquila's filing was primarily driven by rising fuel costs. This Commission docketed the filing as Case No. ER-2001-672. As the rate case progressed, MPS's fuel costs dropped significantly. The rate case eventually was settled through a unanimous stipulation and agreement in February 2002 for an annual rate decrease of $4.3 million.

While Aquila's financial problems are significant and these problems are expected to continue through the next year, there is no immediate threat to Aquila's Missouri ratepayers through an increase in rates. If Aquila files for a rate increase for its MPS or L&P service areas, to recover Aquila's higher costs related to problems generated from its nonregulated business operations, the Commission has several ratemaking options it can employ to prevent a negative impact on Aquila's Missouri ratepayers.

To prevent or mitigate Aquila's higher cost of capital from being charged to Missouri ratepayers, the Commission can order the use of a hypothetical capital structure for ratemaking purposes to determine the appropriate mix of debt and equity that is appropriate for MPS and/or L&P. This capital structure would not be dependent on the capital structure currently in effect for Aquila. Aquila's response to the actions of rating agencies and other members of the financial community, while it may be appropriate for Aquila given its current situation, may not result in a capital structure that is appropriate and reasonable for its MPS and L&P utilities. Also, as described above, Aquila's debt costs have increased to a significant extent as a result of actions by rating agencies. The Commission could determine that this higher cost of debt, and potentially higher equity costs should not be passed on to Missouri ratepayers. Instead of using

Aquila's actual cost of debt and equity, the Commission could impute debt and equity rates that it considers reasonable for Aquila's Missouri utilities.

In Aquila's current financial environment, there is an incentive for Aquila to keep liabilities off its balance sheet. This incentive may lead to Aquila acquiring new generation capacity through an accounting mechanism known as an operating lease instead of purchasing the generation assets and recording the acquisition on its balance sheets as an asset and liability on the balance sheet. Under an operating lease, an entity does not record an asset and resulting liability on the balance sheet but only charges periodic lease payments as an expense in the income statement. Under certain conditions an operating lease may be the lowest cost method of acquiring additional capacity in the short run; however, in certain situations it may result in significantly higher costs in the long run than recording the acquisition under the traditional purchase method. The Commission has the ability to determine the appropriate accounting of generation capacity either as a purchase or an operating lease. This flexibility will allow the Commission the ability to disallow higher costs being passed on to Missouri ratepayers as a result of the current financial conditions affecting Aquila.

A. Aquila's Cost Allocation due to Changes in the Organization

In calendar year 2000, Aquila allocated $223,631,917 to its operating divisions and subsidiaries (business units). MPS was allocated $48,542,403 or 22% of the total corporate allocation. Aquila's corporate allocations consist of two groups both organized in specialized departments. The first group provides the traditional "shared service" or pure corporate overhead costs. Aquila refers to these departments as the enterprise support functions (ESFs). ESF costs are allocated to all of Aquila's domestic regulated and nonregulated business units. The other component of corporate allocations are groups that provide services (and incur costs) solely to Aquila's regulated utilities. Aquila refers to these departments as intra-business units (IBUs). These costs are allocated only to Aquila's regulated utilities.

Aquila has developed a comprehensive corporate overhead allocation procedure to allocate costs to its domestic business units. Aquila's primary method of allocating residual ESF and IBU costs is a three-factor formula referred to as the "Massachusetts Formula." Aquila uses the factors of gross profit (margin), net plant in service and payroll to calculate the relative allocation percentage for each business unit to apply to allocable corporate pool dollars.

The example below shows how Aquila allocates certain ESF costs to its domestic business units. Aquila's nonregulated merchant services weighted percentage of (margin + payroll + plant) to (total domestic business unit margin + payroll + plant) is 30.04%. Using an ESF department with $1,000,000, Aquila's Merchant Services business unit would be allocated $300,400 and MPS would be allocated $224,868, or 22.49 % of this cost. The allocation factors used in this example are the actual factors used by Aquila in its last rate case, Case No. ER-2001-672.

	Margin	Payroll	Plant	(Allocation Factor)
Merchant Services	$446,877	$50,065	$419,409	30.04%
MPS	$221,576	$24,845	$700,120	22.49%
Regulated Gas Ops	$260,069	$54,247	$573,409	27.55%
Pipeline Companies	$12,150	$584	$69,799	1.56%
Other Regulated Electric	$130,630	$17,991	$341,033	12.82%
Non-regulated	$21,251	$20,131	$58,488	5.55%
Total	1,092,553	$167,862	$2,162259	100%

In addition to the Massachusetts Formula, Aquila uses other allocation factors to allocate ESF and IBU department costs to its business units. For example, the ESF departments of 4220 (Compensation and Benefits) and 4223 (Human Resource Executive) are allocated based on the ratio of the number of employees in that business unit to the total number of all business unit employees. Also, ESF department 4140 (Risk Solutions) handles Aquila's insurance policies, including worker's compensation policies. The costs incurred during the year by this department are allocated based on the relative dollar amount of claims paid for each business unit.

Aquila's recent corporate reorganization, exit from the wholesale energy trading business, and $1 billion of asset sales could have a significant impact on the dollar amount of Corporate overhead costs allocated from Aquila to its Missouri regulated utilities of MPS and L&P. For example, while Aquila's corporate overhead costs will be reduced by the elimination of corporate employees, the remaining total corporate overhead costs to be allocated will have to be allocated over fewer business units. To illustrate, Aquila allocated approximately $30 million to its Merchant Services business in 2000. The wholesale energy trading business made up a majority of the Merchant Services business and this business has been terminated. The corporate overhead costs that were allocated to Merchant Services business will have to be allocated over a smaller entity with Aquila's regulated utility operations potentially being allocated significantly higher overhead costs.

The Staff has submitted several Data Requests to Aquila concerning corporate allocations and is in the process of evaluating and analyzing this information. The changes in the levels of these allocated costs, as well as the allocation factors themselves, could have significant impacts on the cost of service assigned by Aquila to its Missouri regulated operations.

B. Record Keeping and Affiliate Transactions

In Aquila's last rate case for its MPS operations, Case No. ER-2001-672, the Staff expressed some concerns with the manner in which Aquila was maintaining its books and records. This concern was addressed in the Unanimous Stipulation And Agreement reached by the parties to this case and approved by the Commission in February 2002. Item 13 of that

Unanimous Stipulation And Agreement listed specific reports that will be made available to the Staff. These reports are:

1. MPS and L&P division-specific ledgers on a Federal Energy Regulatory Commission ("FERC") account basis that include both direct and allocated costs by resource code;

2. MPS and L&P division-specific ledgers on a FERC account basis that reflect only direct charges to the divisions by resource code;

3. MPS and L&P division-specific ledgers on a FERC account basis that reflect only costs allocated to the divisions by resource code;

4. Plant and Depreciation Reserve ledgers for the MPS and L&P divisions that show beginning month balances, additions and retirements, and ending month balances;

5. Aquila Enterprise Support Function ("ESF") and InterAquila Business Unit ("IBU") department costs allocated to the MPS and L&P divisions on resource code basis; and

6. ESF and IBU department costs, by resource code, which are not subject to allocation to the MPS or L&P divisions.

The current financial difficulties being experienced and the corporate reorganization that is currently taking place at Aquila will put a burden on the record keeping commitments made to the Commission. The Staff contends that accurate, timely and complete record keeping by Aquila is essential for the Commission to effectively regulate MPS's and L&P's utility operations, especially in Aquila's current operating environment. The Staff will be monitoring Aquila's record keeping practices to determine if the requirements listed in the Unanimous Stipulation and Agreement are being reasonably satisfied.

In accordance with the Commission's affiliate transaction rules (4 CSR 240-20.015, 4 CSR 240-40.015, 4 CSR 240-40.016, 4 CSR 240-80.015), Aquila is required to provide its current Cost Allocation Manual (CAM) to the Commission Staff on or before March 15, 2003. To comply with Affiliate Transaction rules, the CAM should include the criteria, guidelines and procedures Aquila follows in allocating costs. The CAM should also describe the methods and basis Aquila uses to allocate corporate overhead costs to its individual business units. Aquila's current corporate reorganization should be substantially completed when the Staff receives Aquila's CAM in March 2003. If the CAM is in compliance with the rules, then it will provide information that will allow the Staff to have a better understanding of the impact of Aquila's corporate reorganization on its corporate allocations to MPS and L&P.

The Commission has ratemaking authority over Aquila's Missouri regulated operations. Aquila cannot legally raise the rates to these consumers without Commission approval. In this report, the Staff has begun identifying possible negative impacts on the Missouri regulated cost of service. The identification process serves as a checklist for the Commission, Staff and other interested parties to determine how these items are treated in future rate proceedings.

The Commission has the regulatory tools to address the inclusion or exclusion of the higher capital and interest costs from Aquila's cost of service to the extent the Commission so chooses. Hypothetical capital structures and adjustments provide the Commission the flexibility to address the higher capital and interest costs resulting from Aquila's non-regulated financial activity. Historically, the Commission has rarely used hypothetical capital structures and adjustments to estimate the cost of capital when setting rates of return. Hypotheticals and adjustments have been used only in unique situations, such as when the regulated entity does not issue its own capital or when the capital structure and cost of capital of the parent company issuing the capital is outside of what would be considered normal or typical for a regulated utility.

The current Aquila situation warrants consideration of the use of mechanisms to adjust the cost of capital for MPS and L&P future rate cases. This consideration is warranted to ensure

Aquila's higher cost of capital, due to its unregulated activities, does not increase the rates paid by the consumers of the regulated utility.

Specific examples of mechanisms that can be used to help prevent increased capital costs being passed on to MPS and SJLP ratepayers are: use of a hypothetical capital structure, adjustments to embedded costs of debt and preferred stock, adjustments to cost of equity estimates, use of comparable companies (to more closely reflect the cost of capital for a regulated utility versus a diversified energy company).

Section 4: Service Quality Overview

The ability of a utility to provide quality service to its customers is always an important concern for utility consumers and companies, as well as for the regulatory bodies that examine company activities. Aquila's current and future ability to provide quality customer service is of particular concern in light of Aquila's financial position and the significant organizational, operational and staffing changes that it has experienced. Uncertainty or change in financial, organizational or operational areas would be cause for increased concern about a company's ability to provide quality service, but this complex combination of circumstances and activities requires that increased focus be directed toward Aquila's customer service activities.

Recent events involving Aquila have created an environment conducive to diminished or reduced levels of customer service. Cost-cutting activities forced by a reduction in financial resources can manifest themselves in detrimental customer service staffing reductions, service order back-logs, delayed field work for service reconnections, reduced call-center responsiveness, poor billing practices. These are examples of practices that can directly impact customer service.

Staff has approached this investigation as a means of reviewing and evaluating key indicators of customer service with the intent of determining, to the extent possible, the level of service Aquila has been providing to its customers. It is important to clarify that while customer service indicators or measurements are valuable management tools and can lead to some conclusions regarding customer service, they cannot provide complete assurance that deficiencies are absent from its customer service activities. Such indicators serve an important role, but cannot replace a customer service review that more thoroughly analyzes and examines customer service processes and practices. A comprehensive customer service review of Aquila is planned for sometime in calendar year 2003, assuming the availability of Staff resources is not redirected to a greater priority.

Staff has requested a variety of current and historical information from Aquila to determine its performance regarding customer service. What follows in this section is a brief summary of the areas that Staff is reviewing for potential impact on customer service and the information Staff requested that could indicate negative trends in the customer service received by Aquila's customers. The areas of Staff's analysis that prompted any significant concerns are described more fully in Section 5.F. of this report.

It should be noted that this report does not address any issues with Aquila's planning or purchasing of natural gas supplies for its regulated Missouri utility customers. These concerns, as well as a number of related issues, are addressed in Actual Cost Adjustment (ACA) cases and have been the subject of a number of meetings between the Staff and Aquila.

A. Organizational Staffing

Staff requested information to assess specific organizational changes that have occurred within Aquila and its affiliates to determine if, based on these organizational changes, it appears that staffing levels to support Missouri's regulated operations have been reduced. Staff also asked for information regarding reductions in the total number of employees. Staffing reductions may be cause for concern relative to customers being subjected to a reduction in service quality. Section 5 of this report outlines a number of concerns with the information Staff has received regarding staffing levels that support electric transmission and distribution operations as well as call center support.

B. Customer Service Levels

Staff requested metrics in numerous areas to assess past trends in customer service levels and to determine if any changes have recently occurred or are currently planned to occur in the near future. Reduced levels of service in a number of areas (i.e., call center response times, gas safety-related responses and check intervals, or electric service quality parameters) will prompt further expedited review of Aquila's operations. Section 5 includes considerable discussion on issues related to Aquila's complaint trends, employee turnover, customer service work orders, and call center operations.

The total number of customers served by Aquila is shown in the table below. The numbers include Aquila's total number amount of Missouri gas and electric customers 2001 and the total gas and electric customers of St. Joseph Light and Power Company.

Total Number of Customers Served by Aquila					
Year	1997	1998	1999	2000	2001
Number of Customers	305,368	311,201	320,769	324,088	326,429
Percentage Increase		1.91%	3.07%	1.03%	.72%

Source: Missouri Public Service Commission's Annual Reports

C. Aquila's Response to Reduction in Service Quality

Aquila's responses and/or plans for responses to changes in its quality of service are as important as what quality assurance monitoring Aquila has already performed. Staff requested information to determine specific quality assurance programs Aquila has put in place to assure that service quality levels are not degraded as a result of their reorganization. Section 6 of this report describes the responses that Aquila provided to Staff's Data Requests in this area and any Staff concerns with these responses.

D. Electric Generation Plant

Maintenance of generation plants is necessary to maintain or extend the life of a power plant and to maintain or increase the efficiencies of the plants. Maintenance may be delayed because of an emergency in other resources, to reduce maintenance expenditures or to sell more energy on the spot market. Any delay in maintenance could result in more forced outages which could lead to outages at customers' premises. Forced outages are not planned and typically occur when there is an equipment failure at a generation plant not only due to lack of maintenance, but also due to the age of the plant or an accident. Even if there is not a reduction in quality of energy provided, the delaying of maintenance could result in an increase in costs for generation plants in the future. This will be examined in any future rate cases. Staff reviewed both an eight-year history of outages and the maintenance outage schedule for the next five years for each of the MPS and L&P generation plants along with the projected budget for each plant for the next five years. Section 7 of this report describes the responses that Aquila provided to Staff's Data Requests in this area and any Staff concerns with these responses.

E. Electric Transmission and Distribution

Transmission and distribution equipment are vital to the delivery of reliable power to Aquila's electric customers. Staff reviewed Aquila's transmission and distribution maintenance and construction expenditures and staffing along with tree trimming expenditures for the previous five years and the next year's projected expenditures, for any trends that might indicate a reduction in transmission and distribution service to Aquila's customers. Staff's review of the information provided thus far concluded that tree trimming expenditures for MPS and L&P appear to be relatively stable or increasing. Also, new electric transmission expenditures for MPS have been stable or increasing in recent years but Staff notes that L&P data was incomplete. Staff's review of expenditures for maintenance, construction, and operations were also reviewed. The trends from this review are provided in Section 5 of this report.

F. Electric Resource Planning

One area that a current reduction in the availability of capital could impact is resource planning. Aquila will need more capacity in the near future when its current contract for power from the Aries plant expires. Aquila will also need additional capacity to meet load growth. Staff continues to meet with Aquila on an on-going basis to discuss its resource plans. The most recent meeting was held on November 26, 2002. In addition to these meetings, Staff requested and reviewed information regarding generation construction and budgeted expenditures. Staff also reviewed Aquila's purchased power sales and purchases over the past five years. An increased reliance on purchased power either through a fixed, pre-determined contract or spot market purchases could indicate that Aquila is exposing itself, and eventually its customers, to the risks of the wholesale market. Sections 6 and 7 of this report describes the responses that Aquila provided to Staff's Data Requests in this area and any Staff concerns with these responses.

Section 5: Service Quality Concerns

A. Organizational Staffing

In response to a Staff Data Request, Aquila provided information on staffing and expenditures to support numerous aspects of Aquila's regulated businesses. Some of the information provided was supportive of a continued level of service quality and appropriate support of plant equipment. Some information shows a need for continued Staff monitoring. Other information has resulted in additional Data Requests being sent to Aquila and will be subject to further discussion with Aquila.

One area of concern to Staff is an apparent reduction in call center staffing. From 1998 to 2002, the number of Call Center full-time equivalents (FTEs) has experienced considerable fluctuation. Aquila utilized three call centers during years 1998 through 2001. In 2002, it reduced the number of call centers to two. Call Centers are presently located in Raytown, Missouri and in Lincoln, Nebraska. Aquila provided the following Call Center FTE data for 1998 through 2002:

1998	(3 centers)	175.5 FTEs
1999	(3 centers)	193.20 FTEs
2000	(3 centers)	187.90 FTEs
2001	(3 centers)	222.41 FTEs
2002	(2 centers)	143.00 FTEs

Aquila indicated that its implementation of an interactive voice response (IVR) system during 2001 allowed it to close a call center in Monroe, Michigan and reduce call center staff by approximately 35 FTEs. Aquila indicates that the IVR system allows a certain percentage of its customers to seek/receive self-service. In addition to this change in operations, Aquila states that several of non-call center related functions that were being handled by the call center are now being addressed through the customers' use of the IVR. Aquila believes these changes made it possible to reduce call center staffing without a reduction in service quality. Staff's findings on call center service quality are addressed in subsection B of this section of the report. As presented in that section, call center performance indicators demonstrate a sharp spike in the Average Speed of Answer (ASA) and Abandoned Call Rate (ACR) for the months April, June, July and August 2002.

Another area of concern is an observed reduction in staffing for electric transmission and distribution support. After 2000, L&P transmission and distribution support dropped significantly. It is expected that some staffing changes would have occurred following the merger but the level of reductions created concern. Also, the reduction in staffing at L&P was not offset by an increase in staffing at MPS. In fact, MPS also experienced a significant reduction in electric transmission and distribution staffing following the merger. Staff is checking further to see if some of these transmission and distribution reductions were compensated for with contract labor.

Generation plant staff was constant from 1998 through 2000. In 2001, the first year after the merger, generation plant staff declined by approximately 3%. In 2002, plant staffing decreased by one person. Staff will continue to monitor generation plant staff and will report anything that raises concerns.

The Staff is thoroughly reviewing other metrics used to assess if Aquila is maintaining its system and generation plants adequately. Electric system outage duration and frequency metrics as well as plant outage information are being used in this evaluation.

<u>B. Customer Service Level</u>

As noted in Section 5, Aquila's complaint trends, employee turnover, customer service work orders, and call center operation trends have been identified as areas of interest to describe in this section of Staff's report. Staff will continue to monitor this area through the review of the responses to outstanding Data Requests as they are provided by Aquila.

C. Commission Complaint Trends

Aquila's Missouri Public Service Commission complaints are trending upward. The Missouri Public Service Commission's Consumer Services Department reports the following numbers of Commission complaints for Aquila (gas and electric) from 1999 to 2002. These numbers include the number of complaints regarding St. Joseph Light & Power Company prior to the merger that occurred in 2001.

Year	1999	2000	2001*	2002**
Complaints	97	146	287	224 25 249

Source: Missouri Public Service Commission's Consumer Services Department

*Company filed for a rate increase during this year which may have impacted the number of customer complaints.
**Complaint numbers are through October 2002.

As demonstrated above, Commission complaints increased significantly from the year 2000 to year 2001. The 287 complaints in 2001 represent almost a 100% increase from the previous year, 2000 and an approximate 195% increase from 1999. While year-to-date, 2002 Commission complaints are currently lower than year-end 2001, they are nonetheless approximately 54% higher than 2000 and approximately 130% higher than 1999. This significant increase and rising trend in Commission complaints is an indication of customer concern or dissatisfaction with Aquila. Aquila's rate cases may have increased customer contact with the Commission Staff, but the upward trends are significant regardless. The ice storm that occurred in January of 2002 also impacted customer complaint numbers.

D. Employee Turnover Rate

As part of its investigation, Staff requested Aquila's turnover rates of employees dedicated 100% to customer services for natural gas and 100% to customer services for electric for MPS and L&P for the period September 1997 through September 2002. In its response, Aquila stated that monthly turnover rates for employees by customer services for electric for MPS and L&P were not available.

The monitoring of Aquila's employee turnover rate is an important and effective management tool. Employees are one of a company's greatest resources and the tracking of its turnover rate and monitoring of the reasons employees leave Aquila are imperative. Unless the turnover rate is continuously monitored, Aquila is unaware of the current trend and whether the rate is increasing or decreasing. Without this data, Aquila is unable to measure the effectiveness of implemented policy changes or strategies in relation to its employee turnover rate. The tracking of Aquila's employee turnover rate would provide Aquila with valuable information, i.e., justification for hiring additional personnel and an expected time when employees have completed training and are able to work independently. High turnover rates may be indicative of a less experienced staff and lower job productivity because of additional training requirements and other management considerations.

Staff believes that the possibility exists for customer service quality to decline when a company's employee turnover rate is high. Some of the other possible effects of a high employee turnover rate include replacement of valuable knowledge and possible decline in employee morale.

E. Customer Service Work Orders

Through a Staff Data Request, Staff asked Aquila to provide the number of customer service work orders not completed by month-end, the percentage of customer service work orders not completed by month-end and provide an explanation of any increasing trends. In addition, the Staff requested Aquila to provide any reports that monitor the timeliness of the completion of customer service work orders and to explain any changes or trends.

In its response to Staff's Data Request, Aquila stated that it does not maintain historical tracking of completed service orders at month-end. Aquila also stated in its response to the Data Request response that it has no formal report to track the timeliness of service order completion.

Although Aquila reviews at the end of each workday the service orders not completed and determines the method to complete those service orders, Aquila does not maintain a tracking system of the customer service work orders. Therefore, Aquila is not able to determine whether or not service orders are completed as requested by the customer. In addition, Aquila is not able to determine whether or not 'reconnect for delinquent disconnect service orders' are being completed on the day restoration is requested by the customer, the next working day following the day requested by the customer or on a day following the next day after the request. If Aquila is not tracking the completion of its service orders, it is unable to determine whether or not it is adhering to the Commission's Chapter 13 Billing and Services Practices Rule.

The tracking and documentation of the completion of service orders would serve the Company as a valuable and effective management tool. Aquila would be aware of the effectiveness and efficiency of its personnel. From this documentation, Aquila would also be able to determine any necessary changes to its level of personnel or changes to its techniques or strategies to complete the work process.

In Data Request No. 3906 the Staff requested any documentation Aquila maintains that monitors the activity of the completion of customer service work orders, i.e., average amount of time to complete connect service work order. Aquila's response stated that it uses a Computer

Automated Dispatching (CAD) system to monitor, throughout the day, the status of its service orders. This is real time information. However, this information does not monitor the activity of the completion of work orders continuously. Documentation that monitors the activity of the completion of customer service work orders would serve as an important management tool. This information would assist management in the scheduling of_customer service work orders, i.e., number of customer service work orders that can be performed during a workday. In addition, management would be able to use this documentation to monitor its personnel and determine necessary changes to staffing levels.

F. Performance Measures

In a Staff Data Request, Aquila was asked to provide its Call Center Average Speed of Answer (ASA). The calculation for Aquila's ASA is determined by dividing the total seconds to answer the calls Aquila responds to by the number of calls answered. Aquila's abandoned calls are not included in this calculation. Aquila uses a virtual call routing system to dispatch calls based on the subject matter identified in the initial screening process. The calls are then routed to the first available agent in Raytown, Missouri, or Lincoln, Nebraska, based upon the available agents' approved skillset(s). Aquila indicates that the link between Raytown and Lincoln is seamless. Aquila's response to Data Request No. 2904 is shown in the table below:

Average Speed of Answer 1998-2002												
	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
1998			29	48	47	56	65	53	61	90	46	33
1999	64	69	60	42	58	88	75	64	108	108	58	51
2000	22	18	37	33	57	41	61	43	84	69	72	79
2001	56	19	15	37	67	54	44	36	123	81	26	12
2002	46	40	19	87	63	160	154	108	72	82		

Aquila also noted in its response that beginning in 2001, in addition to the ASA it has been tracking, it now tracks the ASA for emergency calls separately. For 2001, Aquila reported that its ASA for emergency calls was 9 seconds. For the nine months of 2002, its ASA for emergency calls was 24 seconds.

In its response, Aquila states that its yearly ASA average is 53, 71 and 52 for 1998, 1999 and 2000, respectively. But, Aquila's ASA range for 1998 is 29 seconds to 90 seconds, for 1999 is 42 seconds to 108 seconds and for 2000 is 18 seconds to 84 seconds.

Staff notes that Aquila's yearly ASA average increased approximately 34% from 1998 to 1999. But, Aquila's 2000 yearly ASA average returned to one second less than its 1998 yearly ASA average. While the yearly average is significant, review of monthly data is important where peaks can be more easily identified.

The ASA chart clearly demonstrates that for the ten months of 2002 reporting, the ASA has increased from the previous year for seven of the ten months. When comparing the ASA seconds for 2001 to 2000, an increase occurred six of the twelve months. The Staff noticed an improvement in the ASA for the year 2000 when compared to the year 1999. For ten months of 1999, the average speed of answer was greater than 2000. For the months of June, July and August 2002, the Staff noticed a dramatic increase when compared to the same months for the four previous years averages.

Aquila was also asked to provide its Call Center Abandoned Call Rate (ACR). The calculation for Aquila's ACR, which is the percentage of total calls offered that are abandoned before answered by Aquila, is determined by dividing the total number of abandoned calls by the total number of calls offered. Aquila's response is shown in the table below:

Average Abandoned Call Rate												
	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
1998		5.69	4.55	6.95	6.72	8.47	8.50	6.50	7.19	9.64	5.85	4.58
1999	7.7	7.52	7.69	6.12	7.9	10.55	9.06	7.21	11.16	11.11	6.62	5.76
2000	2.49	2.18	4.74	3.90	6.68	4.74	6.87	4.63	9.3	7.55	7.53	8.72
2001	5.3	1.9	1.7	4.2	7.4	6.0	4.7	4.0	11.2	7.6	2.7	1.2
2002	6.2	4.7	2.0	11.3	7.7	19.4	17.5	11.7	7.2	8.5		

Aquila's ACR averages for 2002 were greater than its 2001 averages for nine of the ten months reported. For the months of June, July and August for the year 2002, the Staff noticed a significant increase when compared to the same months for the four previous years averages.

G. Estimated Bills

The Staff requested the five-year monthly history through September 2002 of the number of estimated bills per month. Aquila's responses to Data Request Nos. 2902 and 3909 are displayed in the table below:

Aquila's Bill Estimates					
Year	1998	1999	2000	2001	2002 (Jan. – Sept.
Total Number	90,001	162,367	178,894	128,776	68,055

The Staff observed that the number of bill estimates increased 80% from 1998 to 1999 and 10% from 1999 to 2000. Aquila's estimated bills declined from 2000 to 2001 and a decline is anticipated from 2001 to 2002.

In addition to the customer service issues described above, Staff reviewed a number of electric reliability/service quality related indices. These service quality indices included the following:

- SAIDI – System Average Interruption Duration Index
- SAIFI – System Average Interruption Frequency Index
- CAIDI – Customer Average Interruption Duration Index (SAIDI/SAIFI)
- MAIFI – Momentary Average Interruption Frequency Index

Review of Aquila's values for their MPS and L&P systems showed a number of trends. Aquila's MPS system has historically experienced a significantly higher incidence of momentary outages (MAIFI) than its L&P system. Staff is reviewing this trend in an effort to identify what factors are specifically contributing to this problem. Aquila's L&P system's MAIFI was relatively low in the two years of data that were available. While MPS was not as reliable as L&P in one area it was L&P that in fact had a higher average interruption frequency (SAIFI) than MPS, this is another area of further Staff inquiry. Outage durations (SAIDI) were somewhat higher for MPS vs. L&P. Overall, Staff did not notice any significant trends in degradation of indices in the six years of data reviewed.

H. Gas Safety

An important aspect of Staff's review of Aquila's service quality was how Aquila was performing its gas safety related functions that are regulated and monitored by the Commission. The Commission's gas safety Staff conducts inspections on all operators approximately annually regarding their compliance with Commission rules. Several different gas safety Staff have been involved in these inspections of Aquila. In general, Staff did not find any significant deficiencies with Aquila's gas safety program in its review. Staff's gas safety reviews of the entities that fall under Commission jurisdiction are an ongoing effort. The Aquila Inspection Units were/are scheduled to be inspected as follows:

Aquila Inspections Units	MoPSC Inspection Date
1. Sedalia Area	April 2002
2. Rolla/Salem Area	April 2002
3. Platte City Area	June 2002
4. Maryville Area	August 2002
5. Nevada Area	September 2002
6. Marshall Area	September 2002
7. Chillicothe/Trenton Area	November 2002
8. Lexington Area	November 2002
9. Clinton Area	December 2002 (Scheduled)

MPS initiated and began a cast iron and bare steel main replacement program before a Commission 1989 Rule required those replacements, so they are well ahead of the other natural gas operators in this area. Aquila has replaced its unprotected steel service lines and only has a few yard lines remaining. Aquila is on-track with those replacements. Due to these early replacements and replacements required by the Commission regulations, Aquila's maintenance efforts now are greatly reduced. Staff's review of gas safety items included, but was not limited to, the following:

Gas Safety Item	Status
Leak Response Times	OK (*with a small issue that is likely resolved at this point*)
Leak Survey Intervals	OK
Cathodic Protection	OK (*with an issue being resolved*)
Regulation Station Inspections	OK
Leak Rechecks	OK
Essential Valves	OK
Replacement Programs	OK

There are always "issues" contained in the Inspection Summaries, but Staff's review did not determine anything "out of the ordinary" with Aquila's inspection units. Since Staff performs on-site work at Aquila at least nine different times per year, spread throughout the year, Staff believes that it should be able to identify potential problems as they arise.

Another important area of Staff's review of Aquila's customer service was the reliability of its electric delivery system. Staff received, through Data Requests, electric system interruption, frequency and duration information. The items of interest from this review are described in Section 6.

Section 6: Aquila's Response to Reduction in Service Quality Concerns

Staff requested information to determine what quality assurance programs Aquila has put in place to assure that service quality levels are not degraded as a result of its reorganization. These Data Requests explore whether or not any service quality metrics are being reviewed by Aquila, if any reductions in service quality have been observed, and what Aquila will do if any reductions in service quality are observed in the future.

The first of Staff's Data Requests in this area asked if Aquila had put in place any monitoring to assure no reduction in customer service quality (as determined by the metrics in Data Request No. 2904). Aquila responded to this data request with the following:

Natural Gas and Electric

- Call Center Average Speed of Answer
- Call Center Abandoned Call Rate

Since 1999, Aquila has contracted with the Gallup Organization to complete a monthly customer service survey across three separate categories—"Billing & Image", "Customer Connect" and "Payment Arrangement". These three areas represent the largest areas of customer contact within our organization. Each month a portion of the customer base is surveyed by Gallup to provide results at a 90% confidence level from the responses. The results are then tabulated and scored on a 0-100% scale. Customers having contact with Aquila in the past 30 days pertaining to "Customer Connect" or "Payment Arrangements" are provided in the monthly samples. To obtain a sample for the "Billing & Image" portion, a general sample of our complete customer base is used. This year we have upgraded the process by increasing the sample size and improving the number and types of questions asked. Reports on the three separate areas are compiled and an overall composite score for customer service is determined.

Natural Gas

- Leak Response Times (call received to service man arrival)
- Leak Survey Intervals
- Cathodic Protection Survey Intervals
- Regulator Station Check Intervals
- Rechecks for Classified Leaks Intervals
- Essential Valve Recheck Intervals
- Keeping Current with Pipeline Replacement Programs

Aquila continually monitors to ensure that natural gas service quality is in compliance with or exceeds regulations. All leak responses have historically been documented on forms relating to each individual leak response. These documents are filed in our operating areas and reviewed annually by the Gas Safety Staff of the Commission for compliance with State regulations. Instances in which our response to a gas leak has been found deficient are few in comparison to the total number of responses we make annually. We are implementing a more automated process of summarizing our gas leak response but the system is not fully integrated with our field reports at this time.

The definitions, procedures and intervals pertaining to all mandated leak surveys, cathodic protection monitoring, gas leak classification/monitoring and essential valve maintenance are clearly presented in the State regulations. Our compliance with these regulations is monitored during annual inspections by the Gas Safety Staff of the Commission. All nine of our operating areas are inspected. No major concern regarding our compliance with any of these procedures has been noted during the inspections. The documentation pertaining to these mandated functions is extensive and retained in the individual operating areas.

All mandated pipeline replacement programs were completed well in advance of the scheduled completion dates. Our program was completed in the early 1990's. Our "yardline" replacement program is still in progress and is scheduled for completion in 2005. A summary of the status of this program is submitted annually to the Gas Safety Staff of the Commission.

SAIDI, SAIFI, CAIDI, CAIFI, MAIFI

Aquila has for years monitored performance on these metrics. Reports are reviewed by operations management each month and periodic reports are filed with the state.

Staff's review of this response is generally consistent with information Staff has received through discussions with Aquila and Staff that work with Aquila on some of these issues (i.e., Gas Safety). Staff's review of the data described in Data Request No. 2904 is provided in previous subsections of this section of the report.

Staff's second Data Request in this area asked if Aquila had observed any reductions in service quality metrics (in Data Request No. 2904) and if any management actions had been taken to restore or increase service quality. Aquila responded to this data request with the following:

> After reviewing the response to Data Request MPSC-2904, we do not believe that the information provided denotes any deterioration in service quality over that timeframe.

Staff does not necessarily share Aquila's view of the data provided in response to Data Request No. 2904. This section of the report describes several observations from Staff's review of provided data that have resulted in further inquiries by Staff. The third and last of Staff's Data Requests in this area asked what Aquila will do in the future if any service quality (Data Request No. 2904) changes are observed. Aquila responded to this data request with the following:

> Aquila strives to match a healthy balance of safety, customer service and reliability performance against the cost of achieving that performance. Management would typically focus to a greater extent on significant declines in performance. To the extent that significant declines are noted in any of the metrics described in Data Request No. 2904, management would endeavor to determine the root cause of any such decline, identify measures that could be taken to reverse the decline, analyze the cost to customers of implementing a solution and reaffirm an appropriate baseline for performance. Then management would develop and carry out an action plan designed to re-establish that baseline of performance. The determination of what is significant and the action plan to bring about acceptable performance would, of course, be situationally dependent.
>
> It should be noted that management typically would not wait until performance has declined "significantly" below our standards before addressing issues. For example, our call center performance statistics have not significantly declined but in recent months there has been a level of deterioration in some aspects of the call center's performance metrics. That decline has been identified as occurring due to a combination of internal promotions of experienced call center employees within Aquila shortly before we began experiencing a level of calls greater than we had historically experienced. In order to maintain our baseline performance, Aquila has implemented an action plan to aggressively hire new personnel for the call center and to increase the quality and availability of training programs to all impacted employees.

Through a number of meetings that Staff has held with Aquila and information that has been received through Data Requests, Staff has collected a significant amount of information to monitor several aspects of the service quality that Aquila is providing its customers. The information collected thus far, and information planned to be collected, will provide Staff with the opportunity to review several aspects of Aquila's efforts to maintain or improve its service quality level to its customers. Aquila's success at addressing any future downward trends in service quality will be an item of interest in Staff's ongoing discussions with Aquila.

Section 7: Other Staff Concerns

A. Electric Generation Plant Concerns

At the time of this report, Staff had not had time to conduct a complete review of Aquila's historical and projected outage and purchase power data. Staff will complete its review and continue to monitor this area until such effort is no longer required. Staff will determine if additional action is necessary as dictated by the facts and conditions of the concern.

Staff's initial review of the historical forced and maintenance outage hours was conducted on both a unit-by-unit basis and for the total system. The forced outage rates are very sporadic and do not demonstrate any marked trend. However, projected outage schedules show a lower level of scheduled outages averaged over the next four years than has been averaged over the past eight. Staff believes that shorter outages are an industry trend that needs to be monitored to ensure that forced outage rates do not increase.

The purchase power data reviewed thus far indicates that Aquila has spent less on generation in the last year and more on purchased power as expected since MPS's current contract with the Aries plant is included in this data. However, Aquila's future reliance on purchase power was a point of discussion in Staff's Integrated Resource Planning meeting with Aquila. The L&P expenditure trends are related to maintenance, construction or operations support beyond the recent reduction in generation and the recent increase in purchased power at MPS. These trends are either scattered or relatively stable.

B. Electric Transmission and Distribution Concerns

Staff's review of maintenance, construction, and operations expenditures yielded a number of trends that Staff will be discussing with Aquila in the near future. Staff notes that Aquila's new electric transmission expenditures data for L&P was incomplete.

At the time of writing this report, Staff had not had adequate time to review the information to provide an assessment. Staff met with Aquila regarding this issue on November 26th and is carefully reviewing the information collected in that meeting. Staff will continue to review this area in the future.

Section 8: Aquila Investigations Activity in other States

A. Kansas

On March 11, 2002, the Kansas Corporation Commission issued an Order Initiating Investigation into the standards and criteria for affiliate transactions involving the regulated utility businesses and the unregulated businesses of Aquila. The Order specified that the investigation was necessary with the then recent downgrade of Aquila's debt rating by Fitch, which according to the Order was attributed by Fitch, in part, to Aquila's unregulated businesses. The Order further specified that the purpose of the investigation was to better understand how Aquila will meet its statutory obligation to serve its utility customers in light of its impetus for diversification into unregulated business activities. The Order stated that the investigation would assess the impact of and risks of Aquila's unregulated business activities on its Kansas electric and natural gas regulated business. The Order further specified that the investigation would determine whether any guidelines or criteria should be established about the relationship between the regulated business and the unregulated activities.

As mandated by the Order, Aquila filed its report on June 14, 2002, as a confidential report. The Staff of the Kansas Corporation Commission (KCC Staff) filed its report on October 31, 2002 (Appendix A). The KCC Staff made several initial recommendations. The KCC Staff noted that the organizational structure of Aquila is constantly changing. The KCC Staff opined that the organization of utility businesses along state jurisdictional lines has merit from an accounting and financial perspective. The KCC Staff noted that Aquila's CCAM needs further revision to assure that corporate common costs are being properly assigned and allocated to the regulated utilities and the non-regulated affiliates. The KCC Staff further stated that the

Code of Business Conduct will need to be revised as the business environment dictates. The KCC Staff further recommended that an Affiliates Transactions Policy and Procedures Manual would be of great value.

The KCC Staff also requested that Aquila provide updates on its closure of Aquila Merchant Services' trading positions, associated liabilities and Aquila's general financial health. These updates were to be provided to coincide with the publication of Aquila's financial statements.

Another case of interest in Kansas is Docket No. 01-WSRE-949-GIE (Appendix B). This is an investigation of whether Western Resources, Inc. (WRI) must be required to separate its jurisdictional electric utility business from its unregulated businesses. On May 8, 2001, the Kansas Corporation Commission initiated this investigation. On July 20, 2001, the KCC determined WRI's participation in certain restructuring transaction were not consistent with the public interest and violated Kansas law. The KCC prohibited the transactions. The Order further required WRI to submit a financial plan to restore WRI to financial health, to achieve a balanced capital structure and to protect ratepayers from the risks of nonutility investments.

On January 8, 2002, the KCC expanded its inquiry to assess the impact of and risks associated with WRI's interest in or affiliations with nonutility business activities on WRI's jurisdictional electric utility business.

WRI's Financial Plan was rejected by the KCC because the KCC found that it compounded rather than addressed WRI's underlying problems. The KCC had concerns about steps that WRI had taken to subsidize and enrich its nonutility business and investments to the detriment of the electric utility and its ratepayers. The KCC determined that in order to address these concerns, there must be proper identification of costs and investments attributable to regulated utility and nonutility activities and allocation of common costs and investments between them. The KCC set out a specific plan and steps to be taken by WRI to address the concerns and order WRI to refrain from taking any action that results in a direct or indirect subsidization of nonutility business activities by regulated utilities.

B. Minnesota

In August of 2002, the Minnesota Public Utilities Commission began inquiries into utilities under its jurisdiction that have financial difficulties. The inquiries of which this Staff is aware are directed to QWEST Corporation Inc., Northern States Power Company d/b/a Xcel Energy, and Aquila, Inc., which operates in Minnesota as Peoples Natural Gas & Northern Minnesota Utilities. While Xcel Energy may have more extensive operations in Minnesota, because Aquila, Inc. also operates in Missouri, the Staff has monitored the activities in the docket the Minnesota Commission established for its inquiry into Peoples Natural Gas & Northern Minnesota Utilities.

On August 16, 2002, the Minnesota Public Utilities Commission (MPUC) issued a Notice that it would consider whether any action should be taken regarding an inquiry into Possible Effects of the Financial Difficulties at Aquila, Inc. on it operating companies in Minnesota. The relevant companies in Minnesota are Peoples Natural Gas Aquila and Northern Minnesota Utilities Aquila.

In an Order issued on September 4, 2002, the MPUC determined that an inquiry was appropriate and ordered Aquila to file written responses to certain questions from the Commission within 15 days. Aquila filed its Compliance Filing on September 18, 2002 (Appendix C).

In its Compliance Filing, Aquila answered the questions on corporate structure, finance and related issues propounded by the MPUC. Aquila explained that its business focus shifted from a balanced strategy of merchant and global networks to a strategy of operating an integrated utility and a portfolio of non-regulated merchant generation. Its U.S. Network business orientation changed from a centralized utility structure organized around the concept of unbundled services to each operating division to a state-focused, integrated utility concept. Aquila also provided a general description of its current organization of corporate financing for Aquila, its subsidiaries and divisions. Aquila provided information on its financial situation. Aquila also responded to a question about its risks and potential liabilities in regard to Aquila Merchant Services, any other division or subsidiary as part of the SEC energy trading investigation, FERC investigation and any other lawsuits or similar issues. Aquila also responded regarding protection of Minnesota ratepayers.

Various entities also filed comments on this matter, which are attached to this report as Appendices D through F. These entities were the Attorney General of Minnesota, Aquila and Minnesota Department of Commerce.

<u>Section 9: Possible Issues Raised in the Event for Aquila Files</u>

<u>A. Chapter 11 Reorganization</u>

Aquila is an "electrical corporation," a "gas corporation" and a public utility as those terms are defined in Section 386.020, RSMo 2000, and is subject to the jurisdiction of the Commission pursuant to Section 386.250, RSMo 2000.

As the Commission stated in its Report And Order entered December 14, 2000 in Case No. EM-2000-292 (*In the Matter of the Joint Application of UtiliCorp United Inc. and St. Joseph Light & Power Company for Authority to Merge St. Joseph Light & Power Company with and into UtiliCorp United Inc., and, in Connection Therewith, Certain Other Related Transactions*), the Commission is:

> statutory[ily] obligat[ed] to provide continuous regulation of the public utilities of this state. In describing the authority and responsibility of the Public Service Commission, the Missouri Supreme Court has stated that the Commission is:
>
> a fact finding body, exclusively entrusted and charged by the legislature to deal with and determine the specialized problems arising out of the operation of public utilities. . . . Its supervision of the public utilities of this state is a continuing one and its orders and directives with regard to any phase of the operation of any utility are always subject to change to meet changing conditions, as the commission, in its discretion, may deem to be in the public interest. <u>*State ex rel. Chicago, R. I. & P. R. Co. v. Public Service Commission*</u>, 312 S.W.2d 791, 796 (Mo. 1958).

In rejecting a proposed stipulation and agreement that would have limited the Commission's ability to entertain complaints against a Missouri utility, the Commission stated as follows:

> The Commission cannot agree to relinquish it statutory duties as proposed by the parties. The Commission is essentially a creation of the Legislature and, as such, is empowered by statute to carry out certain functions. Among the various statutory responsibilities incumbent on the Commission to perform are the setting of rates (Section 393.150, RSMo), the provision of safe and adequate service

> (Section 393.130, RSMo), the proper litigation of complaints (Section 386.400, RSMo) and other general powers (Section 393.150). The Commission cannot proceed in a manner contrary to the terms of a statute and may not follow a practice which results in nullifying the express will of the Legislature. *Public Counsel v. Missouri Gas Energy* 6 Mo. P.S.C. 3d 464, 465 (1997).

While made in the context of reviewing a stipulation and agreement, the statements above regarding the Commission's duties and obligations are of general applicability. Thus, regardless of Aquila's nonregulated activities, the Commission has both the authority and duty under Missouri law to set utility rates, assure the provision of safe and adequate service and to oversee Aquila's regulated activities.

Although the Commission has authority under Missouri law to regulate Aquila, the issue of federal preemption would arise if Aquila were to seek relief under the federal bankruptcy code. The Staff does not perceive Aquila to be in such financial distress that a bankruptcy is imminent, but the Staff would consider itself remiss if it did not address the issue. Although not experts in bankruptcy law, it is the Staff's understanding that, in the event Aquila were to file for reorganization under Chapter 11, the Commission would only retain exclusive jurisdiction over ratemaking. Title 11 Section 1129(a)(6), in part, provides:

> The court shall confirm a plan only if all of the following requirements are met:
>
> * * * *
>
> (6) Any governmental regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such approval.

Thus, if the reorganization were to entail the transfer of generating plants or other assets, it appears that the bankruptcy court could allow those transfers to take place without any review by this Commission. The Staff believes it is likely that a bankruptcy court would exercise its discretion and allow one or more Commissions in affected states to conduct a review of any such transfer but, ultimately, by virtue of federal preemption, the bankruptcy court would have the final say on allowing the transfer to occur. Both the Minnesota Attorney General's Office and Aquila addressed this issue in detail in comments filed with the Public Utilities Commission of Minnesota in that Commission's Docket No. G007, 011/CI-002-1369 (Appendices E and F to this report). It is noteworthy that, unlike the public utilities this Commission regulates, when a railroad is reorganized under Chapter 11, Congress expressly requires that both the trustee and bankruptcy court consider the public interest (11 U.S.C. § 1165) and that:

> [e]xcept with respect to abandonment under section 1170 of this title [11], or merger, modification of the financial structure of the debtor, or issuance or sale of securities under a plan, the trustee and the debtor are subject to the provisions of subtitle IV of title 49 that are applicable to railroads, and the trustee is subject to orders of any Federal, State, or local regulatory body to the same extent as the debtor would be if a petition commencing the case under this chapter had not been filed, but –
>
> (1) any such order that would require the expenditure, or the incurring of an obligation for the expenditure, of money from the estate is not effective unless approved by the court; and
>
> (2) the provisions of this chapter are subject to section 601(b) of the Regional Rail Reorganization Act of 1973. (11 U.S.C. § 1166).

B. Chapter 7 Liquidation

The Staff has also reviewed Chapter 7 of the federal bankruptcy code, which provides for liquidation of a bankrupt. The Staff notes that the trustee in a Chapter 7 bankruptcy is, among other things, charged with "collect[ing] and reduc[ing] to money the property of the estate for which such trustee serves, and clos[ing] [the] estate as expeditiously as is compatible with the best interests of parties in interest." 11 U.S.C. § 704(1), but finds no provision that requires consideration of the public interest or any deference to state bodies that regulate the types of utilities that fall within this Commission's jurisdiction. Thus, it appears that any role this Commission might have in the liquidation of a bankrupt's estate would be limited to that which the bankruptcy court chooses to allow.

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Kansas Corporation Commission
/S/ Jeffery S. Wagaman

STATE CORPORATION COMMISSION

OCT 3 1 2002

Jeffery S. Wagaman Docket Room

BEFORE THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS

In the Matter of the Investigation Into the Affiliate Transactions Between UtiliCorp United, Inc. (UCU) and Its Unregulated Businesses.	))))	Docket No. 02-UTCG-701-GIG

STAFF REPORT

I. INTRODUCTION

1. On March 11, 2002, the Commission issued its Order initiating an investigation into the standards and criteria for affiliate transactions involving the regulated utility businesses and the unregulated businesses of UtiliCorp United, Inc. (hereinafter referred to as "Aquila").[1]

2. The Commission indicated that an investigation was necessary given the recent downgrade of Aquila's debt rating by Fitch Ratings ("Fitch"). The Commission noted that according to Fitch, the downgrade was attributable, in part, to Aquila's unregulated businesses.

3. According to the Order, the purpose of the investigation is to create an opportunity to better understand how Aquila will meet its statutory obligation to serve its utility customers in light of its impetus for diversification into unregulated business activities.

4. The Commission's Order established the focus of the investigation as twofold, namely: (1) assess the impact of and risks associated with Aquila's interest in or affiliations with unregulated businesses, and (2) determine whether any guidelines or criteria should be established regarding the relationship between the regulated business and the unregulated activities.

[1] Since the time this docket was initiated, UtiliCorp United, Inc. changed its corporate name to Aquila, Inc. In order to reflect the name under which the company is currently recognized, Staff will refer to the regulated business as Aquila. At the time of the April 2001 IPO offering, the name Aquila referred to the energy trading affiliate of UCU. For purposes of clarity in this Report, the energy trading affiliate will be referred to under its new designation of Aquila Merchant Services.

5. The Commission's Order cited certain events that led up to the downgrade. These events are summarized as follows:

(a) In April 2001, Aquila conducted an IPO of Aquila Merchant Services shares.

(b) In November 2001 through January 2002, Aquila announced and completed a short-form merger that recombined Aquila Merchant Services and Aquila.

(c) On February 19, 2002, Aquila filed a petition to intervene in Docket No. 01-WSRE-949-GIE in which it acknowledged the importance of cost allocations and affiliate transactions.

(d) On February 27, 2002, Fitch downgraded Aquila's debt rating from BBB to BBB-, which is Fitch's lowest investment grade. Fitch stated that the downgrade reflected the cash flow drain from Aquila's Energy/Merchant business and the reliance of the unregulated business on Aquila for funding. Moody's Investor Service ("Moody's")and Standard & Poor's ("S&P") have subsequently lowered Aquila's ratings as well.

(e) Aquila has not made any filing with the Commission that notifies or seeks approval for the spin-off or recombination.

6. Aquila was ordered to provide a report describing and explaining its standards and practices for affiliate transactions by June 14, 2002. This report was timely filed. Similarly, Staff was ordered to file a report detailing its findings as a result of the investigation.

7. The scope and objectives of this investigation are set forth in the Order at paragraph 11(C)(i) through (iv). This Report is organized to address the scope and objectives of the Order.

II. WHAT STANDARDS AND PRACTICES ARE IN PLACE TO GOVERN AFFILIATE TRANSACTIONS AND TO AVOID SUBSIDIZATION OF UNREGULATED SERVICES OR PRODUCTS BY AQUILA'S REGULATED UTILITY BUSINESSES. WHETHER THE STANDARDS AND PRACTICES ARE ADEQUATE AND, IF NOT, WHAT STANDARDS AND PRACTICES SHOULD BE INSTITUTED.

8. Organizational Chart. Until recently, Aquila operated regulated or merchant businesses on three continents. The businesses were organized into two groups: Merchant Services and Global Networks Group. Recently, the merchant businesses have been scaled back and renamed Capacity Services. Capacity Services include generation assets, natural gas storage and transportation, gathering and processing assets, and a coal terminal and handling facility. Aquila Domestic Networks now refers to electric and natural gas distribution utilities. Aquila Networks serves 431,000 electric distribution customers in three states: Missouri, Kansas and Colorado. In addition, Aquila Networks serves 874,000 natural gas distribution customers in Missouri, Kansas, Colorado, Nebraska, Iowa, Michigan and Minnesota. Aquila International Networks owns utilities through subsidiaries in Australia, New Zealand, Canada and the United Kingdom. Another group is referred to as Everest Connections and operates in the Kansas City, Missouri, metropolitan area, and offers local and long-distance telephone, cable television and high-speed internet/data services. It should be noted that Aquila is still in a restructuring mode so the organization structure is still changing.

9. Affiliate Contracts. In certain cases there are contracts with affiliates providing services to regulated utilities. In Kansas, for example, there is a contract between Par Electrical Contractors and Aquila's Kansas utilities. Par Electrical Contractors is one of the Quanta Companies, a firm in which Aquila has a financial interest.

10. Cost Allocation Manual. Aquila has developed a Corporate Cost Allocation Manual ("CCAM"). The CCAM provides the organization chart setting out the business units and divisions. The CCAM also summarizes the primary purposes and goals of the business units. Next the CCAM describes the assignment methodologies. According to Aquila, the CCAM is revised at least annually, and will need revision as Aquila downsizes.

11. Allocation of Corporate Assets. Aquila allocates its corporate assets to its individual business units which includes its utility operations. These allocated corporate assets impact Aquila's Kansas jurisdictional rate base, accumulated depreciation and depreciation expense. Aquila is currently undertaking a depreciation study to develop new depreciation rates for the Kansas portion of the allocated assets. Staff anticipates that Aquila will file this depreciation study in the near future for Staff's review and recommendation to the Commission for approval.

12. Pricing of Goods and Services. In pricing goods and services between utilities and unregulated affiliates, Aquila uses asymmetric pricing principles. If the utility provides goods or services to the unregulated affiliate, the unregulated affiliate must pay the greater of fully distributed cost or fair market value. If the unregulated affiliate provides goods or services to the utility, the utility must pay the lesser of fully distributed cost or fair market value.

13. Monthly Report Tracking Transfer of Human Capital between Business Entities. This monthly report utilized hy Aquila helps to make certain that employees are charged to the correct profit centers.

14. Code of Business Conduct. Aquila has developed a Code of Business Conduct ("Code") that covers a variety of topics. The Code is made available to all employees as an online, computer-aided training. Supervisors are responsible to make certain subordinates avail themselves to the training. Violation of the Code may result in disciplinary action. Some of the topics addressed are insider trading, equal employment opportunity, drug-free workplace, and environment, health and safety.

15. Affiliate Rules Training. The Affiliate Rules Training defines an affiliate, lists the unregulated affiliates, defines an affiliate transaction, pricing controls, record keeping,

reporting, information to affiliates, separation of operations, consequences of non-compliance, recording of costs, controls and Federal Energy Regulatory Commission ("FERC") standards. The Affiliate Rules Training was prepared as an online, computer-aided training for all employees. Aquila states that training sessions have been held during the year 2001 with groups of employees, and that management have played an active role in the training.

III. WHAT ACCOUNTING PROCEDURES AND PRACTICES ARE IN PLACE TO CORRECTLY AND EQUITABLY RECORD AND DISCLOSE AFFILIATE TRANSACTIONS AND TO ACCURATELY REPORT ASSETS OWNED AND LIABILITIES ATTRIBUTABLE TO AQUILA'S ELECTRIC AND NATURAL GAS BUSINESSES. WHETHER SUCH PROCEDURES AND PRACTICES ARE ADEQUATE AND, IF NOT, WHAT PROCEDURES AND PRACTICES SHOULD BE INSTITUTED.

16. Cost Allocation Methodologies. The CCAM previously mentioned has three primary purposes:

(a) Provide a consistent method of assigning costs;

(b) Promote operational efficiencies;

(c) Tool for cost control.

Aquila uses direct assignment of costs where possible. As the CCAM describes, the common costs are allocated using department-specific cost drivers to the appropriate states. The Massachusetts formula, which consists of the arithmetic average of gross margin, payroll and net plant is often used where the costs can not be identified with a specific cost driver. Some other cost drivers include gas customers, electric customers, regulated and non-regulated customers, meters by state, employee headcount, gross property, claims expense paid, gross revenue and number of paychecks. The CCAM is a good attempt to assign common costs to specific states and/or product lines. The CCAM is revised annually or more frequently if a material change takes place within Aquila. Examples of material changes that led to the CCAM being revised are the sale of West Virginia Power property and the purchase of the St. Joseph Light & Power properties. The sale or purchase of significant assets impacts many of the drivers used in the allocation process requiring an update. According to Aquila, each driver affected by the sale or purchase of these assets was updated to reflect the change.

Staff notes that a CCAM audit of Aquila's gas operations in Kansas ("KGO") was recently completed. Staff believes that the scope and objectives of this audit are broad enough for the audit to serve as a proxy of cost allocations affecting total Aquila utility operations in Kansas. The KGO audit found no material errors, omissions or concerns.

17. Pricing Controls. The pricing standards in place have been mentioned in the previous section of this report, but will be summarized again:

(a) Goods and services provided to a regulated affiliate must be priced at the lower of cost or market.

(b) Goods and services provided by a regulated affiliate must be priced at the higher of cost or market.

(c) Goods and services procured by competitive bid should be obtained in a manner equitable to all qualified bidders.

18. Transfer or Sale of Assets between Regulated and Unregulated Business Entities. The accounting records are not automated to track sales or transfers of assets between affiliates. The Risk Assessment & Audit Services department periodically requests that the Property Accounting Group perform a manual study and provide a listing if such transactions occurred. The conclusion was that there were no sales or transfers between regulated utilities and unregulated affiliates during the years 2000 and 2001.

19. Financial Statements and Accounting for Each Business Unit or Division. There should be adequate accounting to prepare financial statements for the various divisions and affiliates. Separate accounting and financial statements would send signals of over or under

earning. Separate accounting and financial statements would help to determine if funding is adequate or deficient.

20. Affiliate Transactions. Through a PeopleSoft query, a monthly report of affiliate transactions can be produced. These transactions are direct charges between various subsidiary departments and were not the result of Intra-Business Unit allocations. A separate query has been developed to list the Intra-Business Unit allocations. Aquila seems to be making a serious attempt of recording affiliate transactions accurately.

21. Affiliate Transactions Policy and Procedures Manual. Aquila does not have an Affiliate Transactions Policy and Procedures Manual but plans to have it completed by the end of calendar year 2002. This manual would be complete road map to guide employees on affiliate transactions policy and procedures. The training material is a good start but needs to be expanded.

IV. WHAT IS THE IMPACT ON AQUILA'S FINANCIAL HEALTH AND ABILITY TO PROVIDE EFFICIENT AND SUFFICIENT SERVICE AT JUST AND REASONABLE RATES FROM AQUILA'S INTEREST IN OR AFFILIATIONS AND ASSOCIATIONS WITH UNREGULATED BUSINESSES.

22. Staff has been monitoring Aquila's financial health since the beginning of the crisis in the energy trading industry. Aquila's financial problems are the result of its affiliates' participation in that industry -- not because of abusive practices between Aquila and its affiliates. Aquila has exited the energy trading business, but Aquila remains responsible for the liabilities created by its energy trading unit. To date, Aquila has not been able to definitively quantify those liabilities for Staff. However, Aquila is actively selling assets to ensure it has the liquidity to meet those liabilities.

23. When a jurisdictional utility moves assets and liabilities from under its corporate umbrella, Staff is concerned about how the move affects ratepayers. Staff's concern centers on

the question of whether it takes with it an equitable amount of debt. Staff would have preferred to examine Aquila's planned IPO of Aquila Merchant prior to it occurring. Because that did not happen, Staff is examining the IPO and the reacquisition to determine whether those transactions had a negative effect on ratepayers.

24. The spin-off and reacquisition as it occurred did not in itself harm Aquila's ratepayers, but only because the transaction was ultimately reversed. If Aquila had completed the Aquila Merchant Services spin-off, then Staff believes that ratepayers could have been harmed because of the very small amount of debt assumed by Aquila Merchant Services.

25. During the past decade, Aquila pursued a strategy of growing its non-regulated business units. The growth in non-regulated business is very apparent in the table of annual sales revenues below which shows revenues from non-regulated operations more than doubling in three years.

	Aquila Annual Revenues	2001	2000	1999
Sales:	Natural Gas-non regulated	$19,834.20	$16,783.00	$ 8,540.50
	Electricity-non regulated	17,582.60	9,459.70	7,966.90
	Natural Gas-regulated	964.30	826.50	638.20
	Electricity-regulated	1,099.80	1,208.10	983.80
	Other-non regulated	895.90	697.60	492.10
	Total Regulated Sales	$ 2,064.10	$ 2,034.60	$ 1,622.00
	Total Non-regulated Sales	$38,312.70	$26,940.30	$16,999.50
Total sales		$40,376.80	$28,974.90	$18,621.50

26. The growth in its non-regulated, non-traditional utility business units led Aquila to the decision to separate it regulated business units from its non-regulated business units. By separating these two very distinct business units, Aquila believed investors would he able to make "pure play" investments in either the traditional public utility or the energy trading industry. The two business units possess different risks and by allowing investors to decide

which to hold, stocks of both the merchant services unit and traditional utility would be more attractive to investors. It was management's belief that the sum of the two parts would be more valuable separated.

A. **Aquila Merchant Services**

27. At the time Aquila decided to spin-off Aquila Merchant Services, Aquila Merchant Services had two distinct business units: Wholesale Services providing marketing, trading and commodity risk management services focusing on the energy industry, and Capacity Services that own, operate and contractually control significant electric power generation assets; natural gas gathering, transportation, processing and storage assets; and a coal blending, storage and loading facility.

28. Aquila continued to own both domestic and international utilities. Global Networks Group manages electricity and natural gas distribution networks in the U.S. and in four other countries. This group also provides appliance services, operates communications networks and has an investment in a major provider of field services for utilities and telecommunications companies. Aquila has accumulated a 38 percent equity interest in Quanta Services, Inc. which is one of the largest field services companies in the U.S., serving the maintenance and construction needs of utilities, pipelines and telecommunications companies. Aquila also owned 80 percent of Aquila Merchant Services.

29. Separating Aquila Merchant Services from its parent, Aquila publicly began in March of 2001 with the offer by Aquila to sell up to 17,500,000 Class A common shares (plus an over allotment allowance) of Aquila Merchant Services at $24.00 per share. At the close of this sale, Aquila would own 80,500,000 Class B common shares of Aquila Merchant Services. The shares owned by the public were reclassified as Aquila Merchant Services Class A common

shares with one vote per share while the shares held by Aquila were Class B shares entitled to 10 votes per share. By the end of the offering Aquila owned 80 percent of Aquila Merchant Services but retained 98 percent of the voting power through its Class B shares.

30. In the prospectus, Aquila Merchant Services stated that it was Aquila's intent to distribute its remaining 80,500,000 shares to Aquila shareholders through a tax-free distribution. The distribution would not have raised any additional capital for Aquila.

B. Aquila Merchant Services' Balance Sheet

31. A key question is what assets and liabilities did Aquila Merchant Services take with it at the IPO. As stated earlier, Aquila maintained 98 percent control over Aquila Merchant Services after the initial public offering. But even though Aquila retained control of Aquila Merchant Services, the IPO did create a group of minority shareholders. The table below demonstrates that the IPO did not leave Aquila with a high amount of debt.

Capital Structure Comparison
Aquila (f/k/a UtiliCorp United)

	Pre IPO December 31, 2000	w/o AMS June 30, 2001	Post Re-Acquisition December 31, 2001
Equity	43.70%	45.63%	48.49%
Debt	56.30%	54.37%	51.51%

32. As shown on the table, the "Pre-IPO" December 31, 2000 capital structure includes the Aquila Merchant Services merchant energy unit. This is the reporting period just prior to the announcement of a spin-off. The June 30, 2001 reporting period is the first reporting period after the separation. The capital structure for this period in the table above is that of Aquila only; all of the capital assigned to Aquila Merchant Services was subtracted out. By December 31, 2001, Aquila had made the announcement to re-acquire the outstanding portion of Aquila Merchant Services.

33. It is worth noting that Aquila Merchant Services took with it only $12 million of long-term debt, less than 10 percent of its total capital assigned to it at the time of the IPO.

34. The table above does not answer the question of whether Aquila assigned to Aquila Merchant Services a reasonable amount of debt, that is, an amount of debt consistent with the debt required to finance Aquila Merchant Services' growth over the years. That type of analysis would require an extensive amount of Staff resources. It is not necessary, though, to perform such an analysis because Aquila chose not to complete the distribution of Aquila Merchant Services stock. Aquila Merchant Services always remained consolidated on Aquila's financial statements. Had Aquila chosen to complete the distribution of Aquila Merchant Services, it would have been necessary for Staff to investigate if an equitable portion of Aquila's debt was assigned to Aquila Merchant Services.

C. Decision to Re-Acquire Aquila Merchant Services

35. The decision to merge the two companies such a short time after the IPO was based on significant changes in the economy and energy trading industry. These changes restricted Aquila Merchant Services' access to the capital markets. The changes in economy and this industry affected all of the participants, not just Aquila Merchant Services. It was believed that only those energy traders with significant assets to collateralize loans would have to access the capital markets. In November of 2001, Aquila's Board of Directors made the decision to purchase the 20 percent of Aquila Merchant Services common stock held by the public by offering Aquila Merchant Services shareholders .6896 shares of Aquila common stock in exchange for their Aquila Merchant Services shares. At that time Aquila stock traded at $30.00 per share which was a 15 percent premium over the trading price of Aquila Merchant Services stock.

36. Aquila Merchant Services would not have access to the capital markets and thus could not survive on its own. Aquila Merchant Services hoped that re-merging with Aquila would provide it with a large enough asset base to survive. At the time of the tender offer, Aquila stated that it believed Aquila Merchant Services, with access to the capital markets, could acquire energy related properties at very favorable prices as other energy trading companies sold assets to raise cash. The question arises whether ratepayers would be better off if Aquila had chosen not to re-acquire the 20 percent of Aquila Merchant Services it sold off in the IPO. Many of the issues surrounding this question must be answered by a specialist in securities law, especially the question of whether Aquila, which still had 98 percent control of Aquila Merchant Services, could be responsible for any of Aquila Merchant Services' liabilities. The poor health of the energy trading industry prohibited Aquila from selling any of its Aquila Merchant Services stock into the market in an attempt to reduce its exposure.

37. In June of 2002, Aquila began scaling back its energy trading operations publicly stating its intent to sell it or merge with another. In August, Aquila announced that a sale or merger was unlikely. At this time, Aquila has ceased all energy trading activities with the exception of its capacity services unit whose trading activities are limited to transaction backed by Aquila-owned plants.

D. <u>Aquila's Financial Health</u>

38. The deterioration of the energy trading industry that caused Aquila to exit the business has also caused bond rating agencies to closely scrutinize the credit worthiness of all companies in that industry.

39. Based on the information currently available, Aquila appears to be able to meet its obligation to serve. In July of 2002, it sold 37.5 million shares of common stock and $500

million of senior unsecured notes demonstrating that it can access both the debt and equity markets. Aquila's credit ratings were placed under review for possible downgrade by S&P on April 23, 2002, and by Moody's on May 30, 2002. Moody's downgraded Aquila to non-investment grade (Ba2) on September 3, 2002. Aquila remains investment grade by Fitch and S&P. Aquila's current credit ratings are as follows:

Agency	Rating	Levels above non-investment grade
Standard & Poor's Corporation (S&P)	BBB	Two
Fitch Ratings (Fitch)	BBB-	One
Moody's Investor Service (Moody's)	Ba2	----

40. The reasons given by the ratings agencies included Aquila's announced acquisition of Cogentrix Energy, risks associated with foreign investments, concerns that Aquila lacked the financial resources to support their energy trading operations and an analysis of Aquila's operations under more stringent credit metrics. To increase its liquidity and improve the outlook for its credit ratings, Aquila: ceased all mergers and acquisitions, reduced the dividend by 42 percent, exited from wholesale energy trading business, identified almost $1 billion of non-strategic assets to sell, sold $764 million in debt and equity and targeted over $100 million in cost reductions.

41. Specifically, Aquila has completed or will soon complete the following asset sales:

Aquila Asset Sales As of October 15, 2002	**Net Proceeds (Millions)**
Completed:	
Lockport, N.Y., power project	$ 37.5
Natural gas pipeline and processing assets	265.0
UnitedNetworks (New Zealand distribution utility)	362.0
U.K. gas storage assets	34.9
Quanta Services stock (open market and private sales)	44.0
Mallon credit facility	30.5
Other businesses and assets	22.7

Subtotal	796.6
Pending:	
Texas gas storage assets	180.0

Total asset sales closed or pending	$976.6

Aquila will use the proceeds from the sale of these assets, issuance of common stock and long-term debt to meet its liquidity requirements which is driven by ratings triggers in its credit agreements and cash needs required to settle its remaining energy trading agreements. Aquila maintains that the cash raised from these sales will be sufficient to meet its liquidity requirements.

V. HOW ARE AQUILA'S UTILITY CUSTOMERS PROTECTED FROM THE RISKS ASSOCIATED WITH UCU'S INVESTMENTS IN OR RELATIONSHIPS WITH UNREGULATED ACTIVITIES, WHETHER SUCH PROTECTIONS ARE ADEQUATE AND, IF NOT, WHAT PROTECTIONS SHOULD BE INSTITUTED.

42. Maintenance of Service Quality. The goal here is to encourage Aquila to fund the regulated utilities adequately. Establishment of service quality criteria needs to be developed. Once the service quality standards are established, the reporting and monitoring of service should be pursued to make certain customers are receiving efficient and sufficient services. To accomplish these objectives, the Commission has opened a generic docket on this subject (Docket No. 02-GIME-365-GIE). In addition, the Commission's Division of Public Affairs and Consumer Protection investigates and tracks customer complaints.

43. Hypothetical Capital Structure and Rate of Return In Rate Cases. The purpose of using hypothetical capital structures is twofold: (a) establishes capital costs that are not influenced by the risks of non-regulated businesses, and (b) determines a rate of return that is adequate to provide sufficient and efficient utility services.

44. Separation of Treasury Functions. This proposal is designed to prevent a corporation with a common treasury from taking funds from regulated utilities to pursue unregulated and often more risky endeavors without receiving adequate compensation. Regulated utilities should receive interest income for funds provided and give interest expense

for funds received. This tracking of cash costs would establish an equitable method of rewarding the entities.

45. Separate Financial Statements. Maintenance of accounting records so that separate balance sheets, income statements and cash flow statements could be prepared for each entity would help preserve the integrity of the utility operations. Regulated entities separated from unregulated entities by distinct accounting systems and perhaps legal arrangements would prevent cross-subsidies.

VI. INITIAL RECOMMENDATIONS

46. Organizational structure is constantly changing as Aquila is in the process of restructuring its business entities. Organization of utility businesses along state jurisdictional lines has a lot of merit especially from an accounting and financial perspective. Aquila's CCAM will need further revision to make certain that regulated utilities and non-regulated affiliates are being properly assigned or allocated their fair share of corporate common costs. The Code of Business Conduct will need to be revised as business environment requires. Affiliate transactions appear to have been addressed seriously by the company. However, the development of an Affiliate Transactions Policy and Procedures Manual would be an invaluable guide in this area.

47. Staff requests that Aquila provide updates on its efforts to close Aquila Merchant Services' trading positions, associated liabilities and Aquila's general financial health. Staff believes such updates should be provided to Staff quarterly to coincide with the publication of its financial statements.

WHEREFORE, Staff submits its Report in the above-captioned docket pursuant to the Commission's March 11, 2002 Order.

Respectfully submitted,

Susan B. Cunningham

Susan B. Cunningham, General Counsel
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ATTORNEYS FOR THE COMMISSION STAFF

VERIFICATION

STATE OF KANSAS)
) ss:
COUNTY OF SHAWNEE)

Susan Cunningham, being duly sworn upon her oath, deposes and states that she is the General Counsel for the State Corporation Commission of the State of Kansas, that she has read and is familiar with the foregoing *Staff Report*, and that the statements contained therein are true and correct to the best of her knowledge, information and belief.

Susan B. Cunningham

Susan Cunningham, #14083
General Counsel
State Corporation Commission of the
State of Kansas

SUBSCRIBED AND SWORN to before me this 31st day of October, 2002.

PAMELA J. GRIFFETH
Notary Public - State of Kansas
My Appt. Expires 08-17-2003

Pamela J. Griffeth
Notary Public

My Appointment Expires:

CERTIFICATE OF SERVICE

(02-UTCG-701-GIG)

I hereby certify that on this 31st day of October, 2002, I caused a true and correct copy of the above and foregoing *Staff Report* to be deposited in the United States Mail, postage prepaid, addressed to the following persons:

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Susan B. Cunningham

THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS

Before Commissioners: John Wine, Chair
Cynthia L. Claus
Brian J. Moline

In the Matter of the Investigation of Actions of Western Resources, Inc. to Separate its Jurisdictional Electric Utility Business from its Unregulated Businesses.	))))	Docket No. 01-WSRE-949-GIE

No. 51
ORDER REQUIRING FINANCIAL AND CORPORATE RESTRUCTURING BY WESTERN RESOURCES, INC.

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Paragraph Number

The State Corporation Commission of the State of Kansas (Commission) finds that financial and corporate restructuring of Western Resources, Inc. (WRI)[1] is necessary to: (1) achieve a balanced capital structure within the public utility business controlled by or affiliated with WRI; (2) reduce the excessive debt accumulated due to investment in nonutility business ventures; (3) prevent interaffiliate accounting practices and relations that are harmful to WRI's public utility business; and (4) protect ratepayers from the risks of WRI's nonutility business ventures in the corporate family controlled by WRI.

By this Order, the Commission (1) rejects the plan proposed by WRI; (2) directs WRI to reverse certain accounting transactions; (3) directs WRI to transfer its KPL utility division to a utility-only subsidiary of WRI, after Commission review and approval of a plan to be submitted by WRI within 90 days of this Order; (4) institutes interim standstill protections to prevent harm to WRI's utility businesses as a result of their affiliation with WRI's nonutility businesses pending adoption of final requirements relating to such affiliation; and (5) institutes an

[1] All references to WRI refer to the entity now known as Westar Energy, Inc. All references to Westar Industries refer to Westar Industries, Inc. a wholly owned subsidiary of WRI.

investigation into the appropriate type, quantity, structure and regulation of the nonutility businesses with which WRI's utility businesses may be affiliated.

I. Introduction and Overview

1. WRI is a holding company, providing electric service and owning stock in utility and nonutility businesses. At the holding company level, WRI provides retail electric service in parts of Kansas as KPL. WRI also provides retail electric service through its wholly owned subsidiary, Kansas Gas & Electric Company (KG&E). In total, WRI, including its subsidiary KG&E, provides retail electric service to approximately 636,000 customers in the state of Kansas. WRI and KG&E are both certificated electric public utilities subject to the jurisdiction of the Commission pursuant to K.S.A. 66-104 and 66-131. Collectively, WRI's electric businesses have been referred to in this proceeding as Western Resources Electric Business or WREB. WRI also owns 100 percent of Westar Industries, Inc., a holding company which owns several nonutility businesses, most prominently ONEOK and Protection One.[2]

2. Prior to 1996, WRI was almost exclusively an electric and natural gas public utility. As of December 31, 1995, WRI employed approximately $3.4 billion in total capital. WRI's capitalization at that time consisted of long-term debt in the amount of $1.4 billion, short-term debt in the amount of $0.2 billion and $0.1 billion in quarterly income preferred securities (QUIPs).[3] At that time, WRI had equity of $1.7 billion, which represented approximately 50 percent of its total capital structure. Proctor Direct at 7, 12-13, 20 and Staff Exhibit No. JMP-5.

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[2] Additional information on WRI's corporate structure is contained in this Commission's Order of July 20, 2001.

[3] QUIPs are obligations to securities holders which have both debt and preferred equity characteristics. For example, WRI may deduct for income tax purposes the dividends payable to the securities holder as interest expense.

3. Since 1996, WRI has employed incremental capital to invest in nonutility businesses. As of December 31, 2001, after taking into consideration and adjusting for an impairment charge of $0.65 billion during the first quarter of 2002 for two of its nonutility subsidiaries, Protection One, Inc. (Protection One) and Protection One, Europe, WRI's consolidated debt and equity were $3.6 billion and $1.2 billion, respectively, for a total of $4.8 billion in capital. Without the impairment charge, WRI's total capital would have been $5.4 billion, including $1.8 billion of equity. Consequently, the equity component of WRI, on a consolidated basis, fell to approximately 25 percent of total capital. Proctor Direct at 7, 12-13, 20 and Staff Exhibit No. JMP-6.

4. WRI currently files consolidated financial statements that include the results and standing of Westar Industries, one of WRI's wholly-owned subsidiaries which currently holds WRI's investments in most of its nonutility businesses. Both WRI's regulated electric utility operations and its nonutility business ventures are represented in its consolidated financial statements. WRI also prepares consolidated financial statements for Westar Industries, consisting of the financial results and standing for its investment in ONEOK, Inc. (ONEOK), Protection One and other miscellaneous nonutility investments.

5. In Westar Industries' consolidated financial statements, as of December 31, 2001, WRI attributed only $0.5 billion of its $3.6 billion of consolidated debt to nonutility businesses. Proctor Direct at 9 and Staff Exhibit No. JMP-6. However, Commission Staff witness James Proctor found that only $1.5 billion of WRI's $3.6 billion consolidated debt was necessary to finance WRI's electric utility operations. He came to this conclusion by employing recognized financial techniques to estimate sources and uses of cash. The remaining $2.1 billion of consolidated debt, he found, was incurred and used to finance WRI's nonutility investments.

Thus, a large amount of debt sits on the books of WRI (which is the corporation in which the KPL utility division is located) that is properly attributable to Westar Industries and its nonutility businesses.

6. Under these circumstances, if there were a corporate reorganization in which Westar Industries was separated from WRI, the present allocation of debt and equity between the two entities would become permanent. The capital structure of WRI's nonutility businesses would have received $1.6 billion of equity from WRI's regulated electric utility operations. Conversely, WRI's actions would have resulted in $1.6 billion of consolidated debt attributable to nonutility businesses being charged to the regulated utility operations. Proctor Direct at 6-7 and Staff Exhibit No. JMP-1.

7. These were the circumstances, among others described in detail in the Commission's Order of July 20, 2001, that led the Commission to expand the scope of its investigation and require WRI to file a new financial plan, aimed at reducing debt, correcting the misallocation of debt between the utility and nonutility businesses, and reforming the manner in which WRI's affiliates interact.

II. Procedural Summary

8. On May 8, 2001, the Commission entered its Order Initiating Investigation. The investigation would address

> whether the participation by WRI and its affiliates in the transactions and relationships described herein, and any other transactions or relationships which may emerge from the investigation, is consistent with Kansas law, including WRI's and KG&E's statutory obligations to provide efficient and reliable service to Kansas customers at just and reasonable rates.

May 8, 2001 Order at 18.

9. On July 20, 2001, the Commission entered its Order that determined that WRI's participation in certain restructuring transactions described in that Order was not consistent with the public interest and contrary to Kansas law. The Commission made permanent the prohibition on consummating those transactions through a "Rights Offering" that would result in a permanent misallocation of the debt and assets within the WRI corporate family as set forth in the Commission's July 20, 2001 Order at 13-20. The Commission specifically declared that the Asset Allocation and Separation Agreement (Asset Allocation Agreement) between WRI and its wholly-owned subsidiary, Westar Industries, through which the misallocation of assets and debt was established was null and void. July 20, 2001 Order at Ordering ¶¶ (B)-(F).

10. The Commission's July 20, 2001 Order further required WRI to submit a financial plan to restore WRI to financial health, to achieve a balanced capital structure and to protect ratepayers from the risks of nonutility investments. July 20, 2001 Order at Ordering ¶ G. In judging the reasonableness of a proposed financial plan, the Commission proposed to evaluate not only financial plans but also accounting practices under the following two important criteria. That is, WRI and any financial plan must:

> i. include an equitable allocation of assets and liabilities among WRI, WREB and WRI's other unregulated businesses based on principles consistent with the manner in which electric and non-electric assets and operations were funded historically; and,
>
> ii. protect WREB's utility customers from harm caused by WRI's investment in unregulated businesses.

11. On November 6, 2001, WRI filed a Financial Plan in response to the July 20, 2001 Order. WRI amended the Financial Plan on January 29, 2002. During the same time, WRI sought judicial review of the July 20, 2001 Order and the October 3, 2001 Order on

Reconsideration in the District Court of Shawnee County, Kansas. Case Nos. 01-C1190 and 01-C1387.

12. On January 8, 2002, the Commission expressly expanded its inquiry to assess the impact of and risks associated with WRI's interest in or affiliations with nonutility business activities on WRI's jurisdictional electric utility business. The Commission invited comments on whether the Commission should adopt standards or guidelines for affiliate relationships to avoid subsidization of nonutility services or products by the regulated operations. The Commission also sought information on whether accounting guidelines or criteria can effectively evaluate, measure and monitor the impact of the financial condition of the holding company on the regulated electric operations (termed WREB); whether accounting procedures and practices are in place to correctly and equitably record and disclose affiliate transactions; whether accounting procedures and practices are in place to accurately report assets owned and liabilities attributable to the electric operations. The January 8, 2002 Order authorized discovery to facilitate the investigation and provide Commission staff (Staff) and other intervening parties a meaningful opportunity to participate.

13. On February 12, 2002, the Commission, noting the Shawnee County District Court's dismissal of WRI's petitions for judicial review and remand, established a procedural schedule for the investigation. The Commission reiterated its two main concerns: First, WRI's assignment to the electric business of debt used for financing of nonutility business investments and operations creates a misallocation of debt between WRI's electric business and its nonutility businesses. Second, WRI's diversification and affiliation with nonutility businesses having stranded investments and other operating difficulties can harm WRI's ability to provide sufficient and efficient electric service at just and reasonable rates. The Commission also

directed WRI to explain whether recent actions taken by WRI to pledge KG&E assets as security for WRI debt and to sell or transfer significant utility assets violate the restrictions of the July 20, 2001 Order that WRI refrain from taking any actions that increase the share of debt attributable to WRI's electric businesses, including entering into any affiliate agreements which violate this principle.

14. On March 26, 2002, the Commission issued an Order that WRI had violated the July 20, 2001 Order by selling the KG&E office building located in Wichita, Kansas, to an affiliate at below book value contrary to Ordering Clauses (B), (C) and (D), of the July 20, 2001 Order. The Commission required WRI to accrue estimated cost of service savings that WRI attributed to the sale of the building. The Commission reserved the appropriate rate treatment for final determination in a subsequent WRI rate proceeding.

15. On April 19, 2002, WRI submitted prefiled written direct testimony for Messrs. David C. Wittig, Paul R. Geist and Arthur H. Tildesley addressing a proposed rights offering, as presented in its amended Financial Plan. On May 23, 2002, Staff submitted prefiled direct testimony for Messrs. James M. Proctor and Jeffrey D. McClanahan; the Citizens' Utility Ratepayer Board (CURB) submitted prefiled direct testimony for Messrs. Stephen G. Hill, J. Randall Woolridge and Ms. Andrea C. Crane; Kansas Industrial Consumers (KIC) submitted prefiled direct testimony for Messrs. John C. Dunn and James R. Dittmer; and MBIA Insurance Corporation (MBIA) submitted prefiled direct testimony for Ms. Kara Silva and Messrs. Frank D. Stern, Louis G. Dudney, Steven T. Almrud, and Thomas B. Hensley, Jr. On June 18, 2002, WRI submitted prefiled rebuttal testimony of Mssers. Wittig, Geist, Tildesley, Michael J. Stadler, Richard A. Dixon, Greg A. Greenwood and Ms. Peggy S. Loyd. On the same date,

several witnesses on behalf of Staff, CURB, KIC and MBIA submitted prefiled cross answering and rebuttal testimony.

16. On July 2, 3, 5, and 8-11, 2002, the Commission conducted hearings. The following appearances were entered: Ms. Susan B. Cunningham, General Counsel, and Ms. Anne Bos, Assistant General Counsel on behalf of Staff; Messrs. Martin J. Bregman, Executive Director, Law, Westar Energy, Inc., Larry M. Cowger, Director, Law, Westar Energy, Inc. and Michael C. Lennen on behalf of WRI; Mr. Walker Hendrix and Ms. Niki Christopher, Consumer Counsel, on behalf of CURB; Messrs. Joe Allen Lang, First Assistant City Attorney and Jay Hinkle on behalf of the City of Wichita, Kansas (Wichita); Ms. Sarah J. Loquist on behalf of Unified School District 259, Wichita, Kansas (U.S.D. 259); Mr. James P. Zakoura of behalf of KIC; Messrs. Karl Zobrist, J. Dale Young and Ms. Glenda Cafer on behalf of MBIA; Mr. James G. Flaherty on behalf of Aquila, Inc. and Messrs. James G. Flaherty, Eric Grimshaw, Vice President and Associate General Counsel, ONEOK, Inc. and John P. DeCoursey, Director of Law, Kansas Gas Service Company, a division of ONEOK, Inc. on behalf of ONEOK, Inc. (ONEOK).

17. On July 2, 2002, ONEOK, WRI, Westar Industries, Staff, CURB and MBIA (collectively referred to as Movants) filed a Joint Motion Approving Partial Stipulation and Agreement. The Movants requested the Commission to issue an order authorizing WRI/Westar Industries to sell its ONEOK Stock in accordance with the terms of the Shareholder Agreement between ONEOK and WRI and authorizing ONEOK, should it elect to do so, to purchase the ONEOK stock from WRI/Westar Industries. On July 9, 2002, the Commission asserted jurisdiction over the subject matter of the Partial Stipulation and Agreement and conditionally approved the Partial Stipulation and Agreement. The Commission's approval was conditioned

on WRI's commitment that the proceeds from any sale of the ONEOK stock held by Westar Industries to ONEOK or to any other third party, be in cash and that such cash proceeds be used to decrease WRI's consolidated debt without WRI incurring any intercompany payable to Westar Industries.

III. The Commission Rejects WRI's Financial Plan Because it Compounds, Rather Than Addresses, WRI's Underlying Problems.

18. The July 20, 2001 Order rejected, as unlawful and contrary to the public interest, WRI's proposed Asset Allocation Agreement, the rights offering for Westar Industries' stock and the split-off of Westar Industries (which at the time held WRI's interest in nonutility businesses) from WRI to WRI shareholders. The Commission found that the effects of these proposals would be to burden WRI (which after the split-off of Westar Industries to WRI shareholders would consist only of WRI's electric business) with substantial debt related to nonutility, business activities for which debt WRI would be legally responsible. After the split-off of Westar Industries, WRI would then be burdened with the large debt related to its investments held in Westar Industries and be unable to avail itself of Westar Industries' assets to retire the Westar Industries-related debt held by WRI. July 20, 2001 Order at ¶¶ 25-28.

19. Distinct from the problems posed by the proposed split-off. the Commission found that WRI's "junk bond" credit rating was inconsistent with its public service obligations and that the situation required more than mere improvement to "investment grade." July 20, 2001 Order at ¶¶ 42, 58, 64, 85. The Commission stated "[f]ailure to achieve a bond rating similar to comparable utilities will mean higher interest rates." *Id.* at ¶ 42.

20. In rejecting WRI's proposal due to the potential for harm to ratepayers and the public interest, the Commission explained that it was not obligated by statute to wait for

ratepayer harm to occur before acting. July 20, 2001 Order at ¶ 26. The July 20, 2001 Order therefore directed WRI to present a plan, consistent with the prohibitions and parameters set forth in that Order, to restore WRI to financial health, to achieve a balanced capital structure and to protect ratepayers from the risks of the nonutility business. July 20, 2001 Order at 1.

21. WRI did submit a proposal, which is the subject of the instant proceeding. The Commission finds that this new proposal reasserts WRI's design and intent to separate Westar Industries and WRI in a manner harmful to the utility business and its ratepayers. This ill-designed separation would leave WRI with the electric utility business encumbered by $1.6 billion dollars in nonutility debt incurred for the benefit of the nonutility investments of Westar Industries. In its July 20, 2001 Order the Commission found, *inter alia*, that "[t]he resulting debt-equity imbalance in WRI harms WREB and its customers." July 20, 2001 Order at ¶ 11. As explained further below, WRI's present plan does not address the harm which the Commission ordered WRI to avoid, but confirms WRI's intent to proceed in a manner that the Commission has already found to be harmful and contrary to the public interest.

A. WRI's Plan

22. WRI's Plan encompasses two stages. Wittig Direct at 3-4. In the first stage, WRI would offer each WRI shareholder the right to purchase one share of Westar Industries' common stock for every three shares of WRI's stock held on the date of the offering (the "rights offering"). The shares to be sold would range from a minimum of 4.14 million shares (approximately 5.1 percent of outstanding Westar Industries shares) to a maximum of 19.1 million shares (approximately 19.9 percent of outstanding Westar Industries shares). Wittig Direct at 3. The proceeds from the rights offering would be used by Westar Industries to purchase currently outstanding WRI or KG&E debt securities in the market. Wittig Direct at 6.

23. In the second stage, WRI proposed to use its "best efforts" to sell the Westar Industries shares it owns, shares of WRI stock, or a combination of these types of shares, in order to reduce WRI's short and long term debt to $1.8 billion. Wittig Direct at 4. The sale of equities would be triggered if Westar Industries' shares close for 45 consecutive trading days at a price that is 15 percent above the price necessary to reduce the debt to an amount less than $1.8 billion based on the debt reported in the most recent SEC Form 10-K or 10-Q. This sale would not occur prior to February 2003. *Id.*

24. WRI states that two features of the plan reduce the price for Westar Industries stock that would be necessary to trigger the sales obligation: (1) the level to which WRI's consolidated debt would need to be reduced in order to trigger the second stage of the plan would be increased by $100 million on each anniversary of Westar Industries' rights offering; and (2) WRI commits to reduce its debt by $100 million provided by cash flow each year following the completion of the rights offering until the separation of Westar Industries is consummated. Wittig Direct at Exhibit DCW-1; Exhibit A; Amended and Restated Financial Plan at 15. This latter debt reduction would be in addition to the debt reduction effected by Westar Industries' rights offering and the second-stage equity sales. *Id.*

B. The Commission's July 20, 2001 Order

25. In the July 20, 2001 Order, the precursor to the instant proceeding, the Commission considered WRI's actions to separate the nonutility business activities of WRI through a rights offering for stock in Westar Industries and a subsequent distribution or "split-off" of Westar Industries through WRI's distribution of its shares in Westar Industries to WRI's shareholders. As part of that plan, WRI transferred assets to Westar Industries without allocation of all debt related to the funding of those assets. After completion of WRI's planned rights

offering and subsequent distribution of Westar Industries' common stock to WRI shareholders, Westar Industries would have owned a substantial interest in WRI common stock. WRI would then have been left essentially with only an electric utility business and all of the consolidated debt issued by WRI for funding the utility and nonutility businesses.

26. The July 20, 2001 Order found that a fundamental problem with WRI's plan was that the rights offering for and subsequent split-off of Westar Industries from WRI was based upon a misallocation of assets and debt as required by the Asset Allocation Agreement between WRI/Westar Industries and the Public Service Company of New Mexico (PNM). However, as the Order explained, the assignment of assets and debt within WRI's consolidated group might not have a deleterious effect on the regulated electric utility operations since, without a rights offering for and split-off of Westar Industries, WRI would continue to own 100 percent of Westar Industries' common stock. However, WRI's planned rights offering for and split-off of Westar Industries' stock would have rendered the misallocation of assets and debt permanent. The July 20, 2001 Order summarized the inherent problem of the misallocation of assets and debt and the unjust enrichment of Westar Industries at ¶ 24:

> In sum, all of the Transactions are designed to ensure that at the time of the split off, WRI's electric business will hold significant debt but no Westar [Westar Industries] assets, while Westar will own all of WRI's unregulated assets but will not be responsible for WRI's long-term debt used to acquire them.

27. The Order further explained why such a misallocation of debt would harm WRI's ability to perform its public utility obligations under Kansas law. July 20, 2001 Order at ¶¶ 25-30. The Commission therefore ordered WRI to, *inter alia*,

> submit a financial plan to restore WRI's financial ratings to the investment grade level of similarly situated electric public utilities. This restoration will require WRI to address the various

> causes of the problem, including the financial difficulties created
> by its unregulated businesses.

Id. at ¶ 85. The Commission further specified at ¶ 85 that the plan must be directed to restoring "WRI's financial ratings to an investment grade level of similarly situated public utilities."

C. Permanent Misallocation of Assets and Debt

28. WRI's allocation of assets and debt to Westar Industries -- which the July 20, 2001 Order found contrary to the public interest -- would not be corrected by the new plan. To the contrary, WRI's new plan, like the original plan, would make this misallocation permanent.

29. Under the November 6, 2001 Financial Plan, as amended, WRI proposes that Westar Industries make a rights offering of its common stock to WRI's shareholders. The rights offering would initiate events that would ultimately confirm, and make permanent, the misallocation of assets and debt to Westar Industries. The execution of WRI's present proposal would result in a separation of Westar Industries from WRI, with a misallocation of debt and assets substantially identical to the misallocation of assets and debt provided in the Asset Allocation Agreement. Yet, the July 20, 2001 Order rejected the Asset Allocation Agreement and its misallocation of assets and debt as contrary to WRI's public service obligations.

30. As shown by the analysis of Staff witness Proctor, as of year end 2001, WRI attributed to Westar Industries approximately $0.48 billion (17 percent) debt and $2.30 billion (83 percent) equity. Proctor Direct at 9 and Staff Exhibit No. JMP-1. Based on data provided by WRI, Proctor found that this would leave WREB, as a stand alone company, with a capital structure containing $3.11 billion (117 percent) debt and negative $0.45 billion (negative 17 percent) equity as of December 31, 2001. Proctor Direct at 14.

31. However, applying appropriate discounted cash flow analyses and equity funding analyses to the allocation of debt from WRI to Westar Industries demonstrates that WRI should attribute approximately $1.47 billion of debt to WREB. Proctor Direct at 14-15, Staff Exhibit No. JMP-2, Schedule No. 3. Based on this testimony, the Commission therefore finds that WRI failed to properly allocate the assets and debt within the WRI corporate family, and has attempted through its Financial Plan to assign approximately $1.63 billion of debt attributable to nonutility business activities to WRI's regulated utility operations. Leaving this $1.63 billion of debt with WRI after the proposed rights offering for and subsequent sale of Westar Industries' stock (the second stage of WRI's Financial Plan) would mean that WRI's electric business (the only WRI assets remaining) would become financially responsible for debt incurred to finance the nonutility business investments transferred to Westar Industries. To make WRI's electric utility operations carry this $1.63 billion of debt burden, used to fund Westar Industries' nonutility business activities. is not consistent with WRI's public service obligations. Proctor Direct at 14.

32. Put in terms of the capital structure, WRI's misallocation of debt and assets would leave WRI's electric utility business, if viewed as a stand-alone company, with a capital structure ratio of 117 percent debt and negative 17 percent equity. Conversely, WRI's proposed capital structure for Westar Industries is unjustly enriched with 83 percent equity. Such a capital structure does not accurately represent the negative effects of deficient cash flow related to WRI's unprofitable investment in Protection One. Proctor Direct at 11. For example, in the first quarter of 2002, WRI's equity was decreased by approximately $0.65 billion because of an impairment charge (equity write-off) for Protection One and Protection One Europe. Proctor Direct at 22.

33. Had the allocation within the WRI corporate family been made consistent with historic financial requirements of the business operations, WRI's electric utility business would have a capital ratio of 55 percent debt ($1.47 billion) and 45 percent equity ($1.18 billion). WRI's electric utility business, at the rates legally established by this Commission and by the Federal Energy Regulatory Commission, without any misallocation of assets and debt between the utility and nonutility affiliates, generated sufficient cash that the proper capital structure to attribute to WRI's electric utility business is the one described by Proctor, not the one proposed by WRI in its Financial Plan. Proctor Direct at 11, 13-15. The Commission finds that the capital ratio presented by Staff witness Proctor is an accurate representation of WRI's actual operational experience for its regulated electric businesses.

34. WRI asserts that Proctor's "allocation of debt will be arbitrary since the legal obligation to repay any particular loan instrument will not change." WRI Initial Brief at 64. WRI misunderstands the point. The Commission does not view Proctor's cash flow analyses as intended to suggest a change in the legal location of the indebtedness. Rather, Proctor's analysis explains how this very legal location represents the misallocation of debt and assets within the WRI corporate family under WRI's proposed plan.

35. WRI, through the testimony of its witness Paul Geist, takes issue with Proctor's cash flow analyses. Geist testified that one cannot "...trace the money..." or "...track the flow of funds...from source to use..." Geist Rebuttal at 5 and 7. However, Geist misstates or misunderstands Proctor's analyses. Proctor agreed that analysts cannot track the specific source for one dollar to its specific use in a diversified corporation, and he did not purport to have done so. Proctor Direct at 14. Proctor explained, however, that it is not necessary to do so to estimate

the sources and uses of cash funds within a diversified company in an aggregated and ultimately, disaggregated basis. Proctor Direct at 14.

36. In support of this position, Proctor explained that diversified companies such as WRI receive funding from multiple sources (*e.g.*, customer payments, stock offers, debt issuances) and use the funding for multiple purposes (*e.g.*, purchasing supplies, investing in capital assets, providing customer service --and all for more than one business activity). It is difficult or impossible to know whether, for example, a particular dollar raised from a particular debt issuance or customer payment went, to the purchase of a particular supply item or the investment in a particular piece of equipment. However, companies can determine the total amounts of funding received from each source (*e.g.*, customer payments, debt and stock issuances) and the total amount expended on objects of expenditure (*e.g.*, supplies, customer service, investment, operating expenses). In fact, cash flow analyses are regularly and routinely employed by corporate finance experts to perform such tasks or analyses in evaluating businesses and business investments. Proctor Direct at 14-15.

37. Proctor further explained that WRI itself performs cash flow analyses on a consolidated and deconsolidated basis. In order for WRI to prepare cash flow statements for Westar Industries, it needs to separate the sources and uses of WRI's consolidated cash flow between WRI and Westar Industries. Proctor makes clear that the separation of the sources and uses of WRI's consolidated cash flow between WRI and Westar Industries is the same task that he performed for this proceeding. Proctor Direct at 14-15. In addition, Proctor explained, as shown in Staff Exhibit No. JMP-2, that a cash flow analysis for WRI's electric business is the difference between the cash flow analysis for WRI and the one for Westar Industries.

38. The Commission concludes that Proctor's approach is reasonable and appropriate for evaluating the capital structures proposed under WRI's plan. In short, because WRI has, as discussed herein and in the July 20, 2001 Order, placed the nonutility activities in Westar Industries and left WRI with the electric operations, the construction of a cash flow analysis for WRI's electric operations, can be derived from a comparison of the data available for WRI with that of Westar Industries.

39. WRI further argues that it was arbitrary for Proctor to begin the cash flow analyses with the calendar year 1998. Geist Direct at 12. Proctor explained that he had reviewed the capital structure for WRI's electric operations as of December 31, 1997, in a prior docket, and found the capital structure at that time to be representative for WRI's electric utility business, as a stand-alone company. Proctor Direct at 12. Proctor checked his cash flow analysis with an alternative, an equity funding method that employed financial data back to 1995. Proctor Direct at 17-21. Proctor's alternative analysis resulted in an estimated $1.56 billion for the amount of debt incurred by WRI for the benefit of Westar Industries, compared to the $1.63 billion estimate derived by his discounted cash flow analyses. Proctor Direct at 17. Proctor stated that the results are sufficiently close to lend support to the discounted cash flow analyses. The Commission agrees and concludes that Proctor's cash flow analyses presented reasonable and accurate representations of what the capital structure would have been for WRI's electric utility operations, as a stand alone company, absent the misallocation of assets and debt through interaffiliate transactions.

40. In sum, the Commission must reject any proposal that is based and perpetuates the misallocation of debt and assets between utility and nonutility businesses.

41. WRI seeks to justify its Financial Plan, as amended, in terms of the debt reduction potential. But the Plan would obtain that debt reduction using the very devices that make the misallocation permanent: Westar Industries' rights offering and WRI's subsequent sale of WRI's investment in Westar Industries' stock. There is substantial uncertainty as to whether the rights offering by Westar Industries and subsequent sale by WRI of its investment in Westar Industries' stock will produce the cash envisioned by WRI. That is, WRI cannot guarantee that the market value for Westar Industries' stock will generate sufficient proceeds to reduce WRI's consolidated debt to an appropriate level.

42. In contrast to the uncertainty over the amount of debt reduction, there is certainty that Westar Industries' rights offering and WRI's subsequent sale of WRI's investment in Westar Industries' stock will make permanent the present misallocation of assets and debt. Only if the cash proceeds envisioned by WRI are achieved will that misallocation be decreased. WRI's Financial Plan, if successful, requires it to decrease debt to $1.8 billion. However, WRI's Financial Plan would still leave WRI and its utility businesses with $0.3 billion greater debt than appropriate. The Commission may not adopt a plan that subjects WRI to definite adversity, in the hopes that this adversity will be overcome by uncertain cash flow from a rights offering and sale of Westar Industries' stock. For this reason alone, the Commission must reject WRI's debt reduction plan. The facts on which the Commission bases its findings of uncertainty as to the cash proceeds are discussed next.

D. Undue Ratepayer Risk and Substantial Uncertainty

43. As the Commission's July 20, 2001 Order stated, restoration of WRI's financial health means not merely a bond rating of investment grade, but a bond rating comparable to utilities facing similar utility-related risks. July 20, 2001 Order at ¶¶ 42 and 85. The record

shows that WRI's rights offering plan will, assuming it is successful as proposed, still leave WRI with too much debt.

44. WRI's Financial Plan, as amended, proposes a reduction of debt to $1.8 billion which, because it does not include all of WRI's consolidated debt (the QUIPs obligation to securities holders of $0.2 billion was omitted), is properly seen as a reduction to $2 billion in consolidated debt. Proctor Direct at 48. Even if WRI's plan, with its proposed reduction to $2 billion in debt, were achieved, WRI would have a capital structure of more than 68 percent debt, and less than 32 percent equity. Proctor Direct at 48 and Staff Exhibit No. JMP-10, Schedule No. 2. This ratio is well above the debt to equity ratio typical for an electric public utility. Dittmer Direct at 10. The average common equity ratio for electric public utilities located in the Midwest is approximately 44.5 percent. Dittmer Direct at 10, citing Value Line Investment Survey for 2002, Central Electric Utility Group, April 5, 2002, at 695. Moreover, successful implementation would, in fact, decrease WRI's cash flow for the years 2003 and 2004 by $27.6 million and $66.5 million, respectively. Proctor Direct at fns. 56-57, Staff Exhibit No. JMP-10, Schedule No. 1.

45. The record shows that WRI's plan -- even if it works as WRI states -- would fall hundreds of millions of dollars short of the debt reduction embodied in alternative proposals presented to the Commission. Furthermore, WRI's plan would likely result in a capital ratio still excessively weighted with debt, as compared to other proposals. Because there are other alternatives working in combination, as discussed below, that are substantially more likely to produce the required results, and substantially less likely to fall short and thereby perpetuate the ongoing damage to the public interest, the Commission must reject WRI's Financial Plan, as amended.

46. In summary: Adopting WRI's Plan would subject ratepayers to substantial risk and uncertainty that WRI will ever resolve its financial problems, while impairing its ability to provide sufficient and efficient electric service at just and reasonable rates. Even if WRI's Financial Plan, as amended, meets its stated goals, the Plan would neither achieve debt reduction sufficient to correct the misallocation of debt and assets, nor bring WRI's debt-equity ratio in line with that of other public utilities. These deficiencies, as well as the permanent misallocation of assets and debt within the WRI corporate family described above, require the Commission to reject the proposed plan as inconsistent with WRI's public service obligations.

E. Commission Inaction Not Supported by WRI's Arguments

47. According to WRI, the record demonstrates that WRI has not been imprudent, that there are no parties asserting that WRI has engaged in fraud, that WRI has reduced rates in recent years, that WRI's embedded cost of debt has not increased, that there is no credible evidence of cross-subsidization, that WRI's stock has outperformed the Dow Jones Utilities average (and Empire District Electric Company, Great Plains Energy, and Aquila) in the last two years, and that electric service has been provided reliably and will be provided reliably in the foreseeable future. WRI Initial Brief at 1-3, 16-18, 33-47, and 64-68; WRI Reply Brief at 1-5, 21-25,28-29, and 36-46. WRI states that: "[t]here simply is no evidence in this record upon which the Commission can base a proper finding...that any customer or creditor of the Company has been harmed in any way." WRI Reply Brief at 5.

48. These arguments do not address the circumstances that require Commission action; nor do these arguments address the factual underpinnings of the July 20, 2001 Order. As stated above, it is undisputed that WRI's debt is excessive and its credit deficient. The record demonstrates that the adverse financial condition in which the electric utility businesses find

themselves was caused by WRI's nonutility investments and use of the regulated utility to support nonutility activities. These realities, again, underlay the Commission's July 20, 2001 Order, which directed WRI to

> present a plan, consistent with the foregoing prohibitions and parameters set forth in this Order, to restore WRI to financial health, to achieve a balanced capital structure, and to protect ratepayers from the risks of the nonutility business.

July 20, 2001 Order at ¶ 42.

49. The Commission need not wait for harm to occur in the form of increases in rates or decreases in reliability. The Commission instead can draw reasonable inferences from the facts in the record. It can reasonably conclude, and does so here, that a capital structure with excess debt, in place for well over a year, in a context where the company not only has not corrected the situation but has proposed measures which are likely to leave the debt problems on the books of the utility, will cause harm to the electric utility business and its customers.

50. WRI also argues that it recently refinanced some of its debt without increasing its embedded cost of debt. WRI Initial Brief at 35. But a refinancing that did not result in an increase in embedded debt cost is not surprising where interest rates have declined to the lowest levels in years. The embedded cost could have and should have been lower if WRI's credit rating had been better. Dunn Direct at 11-12.

51. Also, WRI states that its Protection One subsidiary has experienced positive cash flows in the past two years. WRI Initial Brief at 18. However, the Commission believes that merely examining Protection One's cash flow for the past two years does not provide a complete understanding of the negative effect of Protection One's historic, deficient cash flow and operating losses on WRI. According to KIC Exhibit No. 23 (Protection One SEC Form 10-K for

period ending December 31, 2001, at 16), Protection One had losses in 1997 of $42.3 million; in 1998 of $17.8 million; in 1999 of $80.7 million; in 2000 of $57.2 million; and in 2001 of $86.0 million. As evidenced by Protection One's historic operating losses for 1997 through 2001 and by Protection One's equity write-off in the first quarter of 2002, WRI's investment in Protection One has had a substantial negative impact on WRI's capital structure.

52. In sum, the record compels rejection of WRI's proposed plan, and the Commission hereby does so. The Commission is statutorily obligated to protect the public interest in reliable, safe, and efficient electric operations at just and reasonable rates. The continued existence of the conditions identified in the July 20, 2001 Order precludes any finding that WRI's current conduct is consistent with its statutory obligations to serve the public. Further, the continued existence of the misallocation of debt and assets among the WRI corporate family would unjustly enrich the nonutility businesses of Westar Industries at the expense of WRI's regulated electric operations and continues to provide WRI with incentive to propose financial plans inconsistent with the public interest and contrary to the directives of the July 20, 2001 Order.

IV. WRI Must Reallocate and Reapportion Debts and Assets Equitably Within the WRI Corporate Family and Separately Incorporate the Jurisdictional Electric Operations as a subsidiary of WRI.

A. The Commission's Authority and Responsibility to Fashion a Remedy To Protect Utility Interests

53. An understanding of the Commission's legal authority and responsibility to respond to the WRI problems presented by this record is best obtained by reviewing first the legal context, and then the factual context. Each is discussed next.

1. The Legal Context

54. Kansas law provides the Commission with broad authority and obligation to oversee and protect the integrity of utilities that serve Kansas ratepayers. Pursuant to K.S.A. 66-101, the Commission "is given full power, authority and jurisdiction to supervise and control the electric public utilities . . . doing business in Kansas and is empowered to do all things necessary and convenient for the exercise of such power, authority and jurisdiction." K.S.A. 66-101(d) provides the Commission with investigatory powers: "If after investigation and hearing it is found that any regulation, measurement, practice, act or service complained of is unjust, unreasonable, unreasonably inefficient or insufficient, unduly preferential, unjustly discriminatory, or otherwise in violation of this act or of the orders of the commission ... the commission shall have the power to substitute therefore such other regulations, measurements, practices, services or acts, and to make such order respecting any such changes in such regulations, measurements, practices, services or acts as are just and reasonable." K.S.A. 66-101(h) provides that the Commission "shall have general supervision of all electric public utilities doing business in this state and shall inquire into any neglect or violations of the laws of this state." The section further provides that. "the commission shall carefully examine and inspect the condition of each electric public utility, its equipment, the manner of its conduct and its management with reference to the public safety and convenience." K.S.A. Section 66-101(g) provides that "the provisions of this act and all grants of power, authority, and jurisdiction herein made to the commission, shall be liberally construed, and all incidental powers necessary to carry into effect the provisions of this act are expressly granted and conferred upon the commission." This statutory authority supports the Commission's actions taken in this order.

55. WRI, in contrast, argues that: (1) the existence of statutory provisions addressing affiliated interests, as set forth in the Holding Company Act and K.S.A. 66-125, shows that Commission authority does not extend to securities issuances of nonutility subsidiaries of public utilities, Initial Brief at 20, 24; (2) Commission action to prohibit the rights offering is "an inappropriate invasion of management prerogative and authority," Initial Brief at 26; (3) the Commission does not have broad jurisdiction over transactions that "may affect" jurisdictional utilities, Initial Brief at 29; and (4) the Commission has no authority to invite third party intervenors to propose business plans for WRI, Initial Brief at 32.

56. WRI's argument distills to the following principle: The Commission has no authority to protect a jurisdictional utility from harm where the source of that harm consists of activities of the utility's affiliates or its holding company, even where utility and nonutility activities are under identical management and even where that management has a history of putting the utility's financial condition at risk by proposing to shift utility equity to the nonutility businesses and leaving the utility with an equity-debt ratio which deviates severely from the utility's historic capital structure and the capital structure of typical utilities. The Commission disagrees. The Commission's statutory power and obligation to assure service is sufficient and efficient at just and reasonable rates does not allow the Commission to look away from this situation, out of respect for a "management prerogative" not specified in statute. Under WRI's statutory reading, a utility could defeat the Commission's comprehensive regulatory authority by arranging relations with a holding company and affiliates such that the harm which the Commission is required to prevent, pursuant to its statutory duty to assure just and reasonable, efficient and sufficient service, has as its source a nonutility entity.

57. WRI argues, Initial Brief at 9-25, that the Commission's authority under K.S.A

Section 66-101 is limited by further statutory provisions. WRI focuses on K.S.A. 66-125 (issuance of securities); K.S.A. 66-1401 (jurisdiction over holding companies; affiliated interests defined); K.S.A. 66-136 (franchise transfers); K.S.A. 66-1402 (submission of contracts with affiliated interests); and K.S.A. 66-1214 (dividend payments). *See also* WRI Reply Brief at 9-10. WRI does not show where and how the broad authority and statutory obligations stated in K.S.A. 66-101 are diminished by statutory language that clearly supplements, rather than supplants, Commission authority. Under WRI's reading, the Commission must look the other way when the cause of harm to the utility is an activity or entity regulated by another provision, even when the activity or entity is controlled by the same management that controls the utility. The statutory language does not support this reading. K.S.A. 66-1401 and 66-1402 are reporting requirements intended to supplement the Commission's authority and assist the Commission in stopping abusive inter-affiliate relations that are harmful to the public interest. Similarly, K.S.A. 66-1214 does not limit the Commission's authority to prohibit dividends, but rather, states the procedures to be employed in doing so. Likewise, K.S.A. 66-125 is a reporting provision intended to accommodate the faster-paced financing transactions in today's business world while providing the Commission financial information about the public utility.

58. Finally, with regard to K.S.A. 66-136, a statute that provides the Commission broad authority over all matters affecting the provision of utility service, WRI argues that case law has limited the applicability of the statute. Citing *Kansas Electric Utilities Company v. Kansas City, Kaw Valley & Western Railway Company* 108 Kan. 285, 289 (1921)(*Kaw Valley*). WRI argues that the statute does not extend the Commission's approval authority to contracts that "may affect" the public utility. However, in that case, the contract at issue involved an unaffiliated business, and not, as here, an affiliated company. *Kaw Valley* did not involve

circumstances where, as here, all the relevant entities are affiliates; nor did it address entities and their managements that mixed utility and nonutility interests to the detriment of the public utility. Even so, the decision on rehearing in *Kaw Valley* shows that the outcome might have been different had further factual showing been made regarding the effect on the regulated entity. The majority court stated that the trial court's factual determination on whether K.S.A. 66-1336 was triggered was correct. *Id.* at 292. On rehearing, the majority court summarized its understanding of the facts, finding that the "contract carries into effect the defendant's franchise and does not assign, transfer, or lease it, nor any part of it, nor refer to or affect it, nor modify, restrict, or defeat its operation." *Id.* at 299. The point is further illustrated from the dissenting opinion where the dissenting court argued that the majority court's decision was based upon a misconception of the facts that would have required Commission approval under K.S.A. 66-136. *Id.* at 301. There was no disagreement between the majority and dissenting court on whether the public utility had the right to harm its ability to perform its public service obligations. No such right existed. *Id.* at 301.

59. WRI further argues, Initial Brief at 26, that Commission action to remedy the financial difficulties of record here would "fundamentally constitute[s] an inappropriate invasion of management prerogative and responsibility." Regulatory deference to a management decision might be appropriate where the management decision at issue is: (i) a reasonable response to the utility's obligation to provide just and reasonable, efficient and sufficient service, and (ii) not subject to a conflict in goals between utility and nonutility activities. As the Commission explained above, these conditions do not exist here.

60. In support of its "management prerogative" argument, WRI, Initial Brief at 26, relies on *Wichita Gas Co. v. Public Service Commission*, 126 Kan. 220, 268 P. 111 (1928) and

Sekan Electric Cooperative Association, Inc. v. State Corp. Commission, 4 Kan. App. 2d 477, 480, 609 P.2d 188 (1980). Neither of these cases, or any of the further cases cited by WRI, involved showings that utility operations were prejudiced or harmed by management's operations from nonutility affiliates.

61. *Wichita* was a rate dispute in which the Court rejected the views of the Commission's expert as to the time period over which an item should be expensed. *Wichita* did not address circumstances where utility financing was distorted to benefit nonutility activities; nor did it address circumstances where management (of both utility and nonutility activities) persists in decisions that are shown to be contrary to the utility interest. In *Wichita*, in regard to Commission argument that the utility overpaid for gas from an affiliated entity, the Court noted that, "[i]t is impossible to declare, on the meager record in this case, either agency or abuse of corporate privilege, in the relation between the Kansas gas companies and the parent organization." *Wichita*, 126 Kan. at 230.

62. In *Sekan Electric*, another rate case, the court upheld the authority of the Commission to adopt a hypothetical equity ratio for purposes of establishing the utility's rate of return. In doing so, as WRI notes, it cited a public utility treatise, which explained that it was management prerogative "to say how much debt should be incurred or common stock issued." However, the language cited by WRI is *dicta*. Moreover, *Sekan* did not involve or address circumstances where: (i) a utility (such as WRI's KPL division) does not have a separate capital structure from the parent holding company that is also used to fund nonutility businesses; (ii) the utility's effective capital structure is established not by independent utility management whose sole allegiance is to the utility, but by management which also has responsibility for nonutility affiliates, thus creating an incentive and opportunity to misuse the utility's financial strength to

support the nonutility affiliates; and (iii) management has responded to this incentive and opportunity by taking actions which are detrimental to the utility's financial strength. There is no prerogative to behave in this manner.

2. The Factual Context

63. The Commission's obligation to protect the public utility from investment in nonutility businesses is triggered when there is a causal connection between the nonutility activities and a substantial likelihood of harm to the regulated public utility. Here, the record shows that: (i) WRI's excess debt is detrimental to WRI's utility activities, (ii) the excess debt was incurred by management's use of the utility to benefit nonutility activities; and (iii) WRI management--which manages both the utility and nonutility activities--proposes to address the excess utility debt problems caused by its investment in nonutility activities with a plan that puts the utility at further risk of being left holding obligations to repay debt incurred to further nonutility activities.

64. The following facts and patterns of fact provide material support for the Commission's authority to act here to protect the interest of WRI's utility operations:

(a) WRI operates the KPL electric business as a division within a holding company structure. Within that holding company structure, human and capital resources are combined. This fact supports the Commission's actions here because this corporate structure allows the holding company to draw on the utility's human and capital resources for use in nonutility business ventures.

(b) Westar Industries, which houses the nonutility ventures, is a holding company owned exclusively by WRI, with which Westar Industries shares top management. Westar Industries has no assets except those conveyed to it by WRI. This fact supports the Commission's exercise of its authority because, in contrast to a context in which utility management is responsible solely for the interests of the regulated entity, utility management here is simultaneously responsible for an entity comprised of nonutility activities, whose interests may be, and have been, in conflict with those of the utility.

(c) WRI has a level of debt well in excess of equity, and a credit rating below investment grade. WRI's debt problem arises because of its financing of nonutility activities. As noted in the opening sections of this Order, in 1995, WRI, then almost exclusively a public utility company, had a total company debt of $1.7 billion. In 2002, after WRI invested in nonutility activities. WRI's total debt climbed to $3.6 billion. In 2001, $2.1 billion of the debt was attributable to nonutility business activities, and only $1.47 billion could reasonably be said to be required for utility operations. Proctor Direct at 17-21; Staff Exhibit No. JMP-1. The excess debt supports the Commission's exercise of its authority here because it increases the borrowing costs of WRI, who may need to seek recovery of those costs from its utility ratepayers, Dunn Direct at 11-12, and because WRI will likely continue to seek to use utility cash flow to make good on part or all of its obligation to repay the debt and interest expense on that debt. *See* Part III of this decision. WRI's retained earnings subsidy for Westar Industries consists of subsidized interest expense payments of approximately $257.6 million for the years 2000 and 2001. Proctor Direct at 18.

(d) WRI's proposed remedy to WRI's debt problem includes a "rights offering" of Westar Industries stock. In the July 20, 2001 Order, the Commission found that this rights offering, if effectuated, would have substantial detrimental effects on the electric operations. Notwithstanding the July 20, 2001 finding, WRI again proposed the use of a Westar Industries' rights offering as the first stage of a plan to remedy financial problems affecting the public utility. The Commission finds here that this renewed proposal would also be detrimental to the interests of the regulated utility operations. *See* Part III of this decision. These facts support the Commission's exercise of its authority to promulgate standards and guidelines to govern affiliate relations within the WRI corporate family because they strongly indicate that WRI management will seek to use utility operations and resources as a vehicle to resolve WRI's financial problems caused by its nonutility businesses, along with its nonutility investment objectives, in a manner that will place the regulated utility at further risk..

65. WRI identifies a series of facts which it states are material to the determination of the Commission's authority here. WRI Initial Brief at 13-18; Reply Brief at 9-10. But as explained next, the facts on which WRI proposes to rely, like the legal precedent on which it relies, vary materially to the circumstances here. Thus:

(a) First, WRI states that relevant actions of its nonutility activities do not affect or are isolated from regulated activities. The Commission concludes that the record shows otherwise. For example, WRI states that the rights offering that was previously rejected by the Commission in the July 20, 2001 Order was for the issuance of securities by a WRI nonutility subsidiary, and therefore fell outside of the Commission's lawful concern. WRI Initial Brief at part IIB. This previously rejected proposal is not before us now; however, as the July 20, 2001 Order explained, the rights offering was part of an integrated plan to merge with the PNM. As explained in that order, the combination of transactions--rights offering, split-off, Asset Allocation Agreement, along with the excess debt and misallocation of debt and equity between WRI and Westar Industries--had direct consequences for the regulated utility operations.[4] Similarly, with regard to the Asset Allocation Agreement, WRI states (in boldface) that **"nor has Westar Energy assumed debt of Westar Industries."** *Id.* This wordplay ignores the facts. WRI incurred debt on behalf of nonutility activities in the first instance. Similarly, WRI states that the "the asset allocation agreement did not in any way affect the public utility franchise of WE [WRI]." *Id.* at 16. However, the Commission found in the July 20, 2001 Order that the Asset Allocation Agreement would have locked in the

[4] *See* July 20, 2001 Order, at Part I: "The Commission finds that the split-off, the asset allocation agreement, the rights offering, the intercompany receivables and the ownership of WRI common stock by Westar [Westar Industries], are interdependent and considered collectively, are contrary to the public interest and pose substantial risk of harm to Kansas electric customers."

obligation of WRI (and its electric businesses), to repay the debt incurred to benefit nonutility businesses and investments.

(b) Second, WRI directs the Commission to evidence presented by its witness Richard Dixon that its utility operations are functioning well and asserts therefore that the utility has not been adversely affected by nonutility business activities. *See* WRI Initial Brief at part III, as well as part IIB. However, WRI does not address the debt problem faced by WRI and, by consequence, its electric business. As stated above, the record shows that this debt problem was caused by WRI's funding of unregulated business activities, including funding secured by WRI's utility operations activities. The record further shows that the utility is burdened by the debt problem by increasing the utility's cost to borrow money. Dunn Direct at 11-12. In addition, WRI's regulated electric business has paid $257.6 million of interest expense for the years 2000 and 2001 on debt properly attributable to Westar Industries and the unregulated investments now housed within that WRI affiliate. Proctor Direct at 18.

(c) Third, WRI urges that its nonutility activities are now doing better, so there can be no future deleterious effect on electric activities. Thus, WRI states that: "Westar Energy's unregulated businesses, including Protection One, do not have a negative cash flow impact on Westar Industries or on Westar Energy." WRI Initial Brief at part IIB. However, the record confirms that: (1) in the five year period of 1997 through 2001, WRI's nonutility businesses had losses and diminution in value that exceeded

$1.7 billion and (2) Protection One continues to be unprofitable. CURB Exhibit No. 9 at 20, KIC Exhibit No. 1 at 4 and 7, KIC Exhibit Nos. 6-8 and KIC Exhibit No. 11. In addition, Westar Industries extends credit to Protection One through a senior credit facility at a subsidized rate of interest. KIC Exhibit No. 3 at 19, KIC Exhibit No. 5 at 3, KIC Exhibit Nos. 23 at 23 and 33, and MBIA Exhibit No. 7.

66. In sum, the Commission finds that the authority and obligations conferred upon it by statute to oversee and protect the integrity of utility operations provide ample basis and obligation for it to act to assure that WRI's ability and obligation to provide utility service on a basis that is just and reasonable, efficient and sufficient, is not compromised by management actions that place the utility at risk for the benefit of nonutility business ventures. The electric franchise received by WRI to provide electric utility service in its given certificated service territories within the state of Kansas as monopoly provider carries with it a public trust to operate in the best interests of its captive customers. The public utility possesses no unqualified right to engage in other nonutility businesses to the extent harm to the public utility results or is likely to result. Under the facts and circumstances of this case, the Commission's statutory authority and duty obligates the Commission to continue its work towards improving the financial and corporate restructuring of WRI. This work will require reversal of certain intercompany transactions that contributed to the present misallocation of debt and assets, movement of WRI's utility operations to a new utility-only subsidiary, and promulgation of standards or guidelines on interaffiliate relations to protect the public utility from harm in the context of WRI's current mix of utility and nonutility business activities. Each of these items is discussed next.

B. WRI Must Reverse Certain Intercompany Transactions

67. Prior to WRI's creation of Westar Industries in February 2000, WRI funded nonutility investments and operations largely by making loans to Westar Industries which were recorded by WRI as intercompany receivables due WRI from Westar Industries. Proctor Direct at 36. During calendar year 2000, WRI converted notes receivable of $1.06 billion owed by Westar Industries to WRI, into an equity investment by WRI in Westar Industries. *Id.* at 36 Westar Industries, in turn, eliminated its notes payable to WRI by $1.06 billion and credited its paid in equity account for the same amount. Proctor Direct at f.n. 29.

68. Proctor explained that, as of December 31, 2001, WRI had contributed approximately $1.95 billion in capital to Westar Industries, including $1.8 billion to its paid--in equity account and $0.15 billion to its retained earnings account. In addition to the series of accounting entries comprising the $1.06 billion intercompany receivable, three further components of the accounting transactions comprising the $1.8 billion at issue are capital contributions provided to Westar Industries related to: (i) the transfer of WRI's investment in ONEOK to Westar Industries; (ii) the transferring of miscellaneous other WRI investments to Westar Industries; and (iii) additional cash investments from WRI to Westar Industries. Proctor Direct at 19; Staff Exhibit No. JMP-4. Finally, WRI's capital contribution of $0.15 billion to Westar Industries retained earnings account relates to the after-tax impact from WRI paying $0.26 billion of interest expense in years 2000 and 2001 on debt used to finance the nonutility investments held by Westar Industries. Proctor Direct at 18.

69. These accounting entries as now recorded by WRI do not fairly represent the economic substance of transactions initially recorded as loans from WRI to Westar Industries. In its July 20, 2001 Order the Commission found that these transactions "taken as a whole, had an

asymmetrical result, benefiting Westar Industries at the expense of WRI." July 20, 2001 Order at ¶ 88. The Commission found that they:

> have no purpose related to WRI's obligation to provide utility service. Whatever corporate goal WRI was seeking to attain, it could have done so in a symmetrical manner that did not disfavor the utility.

Id. at ¶ 89. The July 20, 2001 Order then concluded:

> At this time, the Commission will not require the dividending by Westar [Westar Industries] to WRI of the intercompany receivable or of Westar's ownership of WRI stock. The harm from these two features of the present WRI-Westar Industries relationship stems from their relationship to the rights offering, the Asset Allocation Agreement and the split-off. Because the Order prohibits the rights offering, the Asset Allocation Agreement and the split-off, the Commission does not need to require the dividending of the intercompany receivable and the WRI stock at this time. Should the Commission observe, however, activities relating to these two elements that would cause harm, the Commission will revisit this judgment.

Id. at ¶ 90.

70. The accounting entries, considered alone, do not appear to violate financial accounting standards. Proctor Direct at 36. In the case of a company unaffiliated with a regulated utility, they might be innocent. But the context here is different. Westar Industries is a wholly owned affiliate of WRI. The July 20, 2001 Order found that WRI's regulated utility has been adversely affected by the drain on utility resources by the nonutility business activities conducted within Westar Industries.

71. In the interim since the July 20, 2001 Order WRI has not, as discussed herein, taken action, including action directed by the Commission in the July 20, 2001 Order, to undo the actual and prevent the potential damage to the utility caused by WRI's investment in nonutility activities.

72. In sum, WRI's conduct in the interim since the July 20, 2001 Order compels the Commission to conclude that, as long as the means and incentive remain available, WRI will continue to pursue the very type of separation between utility and nonutilty businesses that the Commission has found to be contrary to the public interest. WRI must cease the use of interaffiliate financing transactions that produce a financial picture which departs from the historic funding of the regulated and unregulated activities, but has been used by WRI as an accounting convention to facilitate and continue its effort to expand nonutility activities. The Commission therefore directs WRI to reverse the interaffiliate transactions described more fully above and in Staff Exhibit No. JMP-4. That is, WRI is ordered to:

(a) reverse the transactions funding Westar Industries' equity with $1.95 billion by debiting Westar Industries' equity and crediting Westar Industries' intercompany payable to WRI by the same amount;

(b) reverse all transactions recorded during 2002 comprising the equity investments from WRI to Westar Industries to reflect such transactions as intercompnay payables to WRI from Westar Industries;[5]

(c) provide the Commission with copies of journal entries recorded subsequent to year 2001 comprising all equity contributions from WRI to Westar Industries; and

(d) make a report, within 30 days of this Order, submitted under oath by its Chief Financial Officer, describing WRI's compliance with these requirements.

[5] The reversal of the accounting entries for the transactions funding Westar Industries' equity account will require WRI to debit its intercompany receivable from Westar Industries by the aggregate amount of all entries recorded to Westar Industries intercompany payable account.

C. WRI's regulated electric utility operations must be separately incorporated as a subsidiary of WRI.

1. Overview

73. The record in this proceeding, as discussed above, shows that WRI has burdened utility assets with debt commitments devoted to unsuccessful nonutility ventures, and that its present plan, like the plan discussed in the July 20, 2001 Order, again favors the interests of Westar Industries over the utility businesses of WRI. The record also shows that WRI's corporate structure makes it difficult, time consuming and costly to monitor, prevent, and correct intercompany transactions that are detrimental to utility activities.

74. Also, while the Commission's requirement that WRI reverse accounting entries that operate to the detriment of the utility operations addresses the past abuses, they do not prevent or protect against future ones. The reversals, by themselves, do not prevent WRI from continuing its efforts to further nonutility business ventures to the continued detriment of the regulated utility operations. Nor do the reversals provide incremental protection to the utility operations from the $1.6 billion of debt issuances whose proceeds were used to serve the unregulated business ventures because WRI, an electric public utility, is still the obligor on that debt not Westar Industries.

75. To prevent WRI's continued misuse of the regulated utility operations to benefit nonutility business ventures, CURB has recommended the complete split-off of management control over electric operations from control over nonutility activities. *See, e.g.*, Crane Direct at 7. However, as CURB itself acknowledges, to require a total split-off at this point would leave the electric utility operations burdened with nonutility debt. The Commission, therefore, cannot find that the type of separation called for by CURB is presently in the public interest.

76. Nonetheless, the Commission does agree with CURB that further insulation of the electric utility operations from other WRI operations are needed to: (i) minimize the burden that WRI's nonutility debt places on the electric operations, and (ii) maximize the likelihood that efforts to exploit utility operations on behalf of unregulated activities are prevented, or, if not prevented, detected and corrected. It is essential that WRI's corporate structure be such that the utility subsidiaries be aligned with the debt issued to fund such utility activities. In the absence of a proper alignment, management has incentive to favor and enrich Westar Industries at the expense of the regulated utility operations.

77. Toward these ends, the Commission concludes that it is necessary to direct WRI to provide, within 90 days of this Order, a proposal, which will be subject to hearing and approval by the Commission, to restructure its corporation so that the KPL electric division is placed in a separate subsidiary of WRI. (KG&E is already located in a separate subsidiary.) That new electric utility subsidiary of WRI could be a subsidiary separate from KG&E, or it could be a subsidiary which holds both KG&E and the KPL electric operations. There is no suggestion that this separation will have any adverse effect on WRI since WRI and its regulated electric businesses are and will remain part of a consolidated group immediately after separate electric utility subsidiary or subsidiaries are formed.

78. This corporate restructuring is necessary to protect the public interest. Accompanying the movement of the KPL utility business to a new subsidiary must be a new cost allocation manual. and specific reporting requirements. These two requirements are discussed next, followed by an explanation of the reasons for the necessity of moving the KPL utility business to a new subsidiary.

2. Cost Allocation Manual

79. As explained throughout this Order, the Commission has concerns about the steps WRI has taken to subsidize and enrich its nonutility business and investments to the detriment of the electric utility and its ratepayers. To resolve these concerns, there must be proper identification of costs and investments attributable to regulated utility and nonutility activities and allocation of common costs and investments between them.

80. Therefore, the Commission directs WRI to review and improve its methodology for documenting and reporting of costs attributable to regulated utility operations and nonutilty business activities and for allocating joint and common costs and investments among the WRI businesses. As recommended by Staff witness McClanahan (McClanahan Direct at 20) and KIC witness Dittmer (Dittmer Direct at 24), WRI shall develop proposed CAM procedures to reflect its proposed corporate structure that follows from this Order. The CAM shall provide the allocation procedures proposed by WRI to allocate joint and common overhead costs and investments to the regulated electric utility subsidiary or subsidiaries and WRI's other affiliates. The proposed CAM shall also fully explain the reasoning for and determination of allocation methods and ratios employed and why they are appropriate. WRI shall provide the proposed CAM to the Commission for review and approval along with the corporate restructuring plan that assigns WRI's electric utility assets and related liabilities to the newly created electric subsidiary or subsidiaries, as required below.

81. Further, subsequent to the Commission's approval of WRI's new CAM, WRI must update and revise the CAM annually. The CAM revisions and updates should reflect changes in the relationship between causation and benefits attributed to WRI's costs and investments. Annual maintenance of a CAM would require WRI's management and the

Commission to review the reasonableness of various cost assignment and allocation schemes in place. As KIC witness Dittmer explains: "...In other words, by consciously reviewing existing policies and considering changed circumstances before committing procedures 'to writing' within the CAM, management would be indirectly encouraged to review the adequacy, equity and reasonableness of cost assignment/distribution policies in place..." Dittmer Direct at 30.

3. Reporting Requirements

82. Once a Commission order is issued approving a new CAM and the assignment of assets and liabilities from WRI to the newly created electric subsidiary or subsidiaries, the jurisdictional electric utility operations shall fully disclose its affiliate relations with the parent company and other nonutility affiliates and comply with certain financial reporting requirements. Those financial reporting requirements shall include the quarterly filing of income statements, statements of financial position (balance sheets) and statements of cash flow for the electric utility subsidiary or subsidiaries and its holding company parent, WRI. The affiliate reporting requirement proposed in the January 8, 2002 Order should be adopted and implemented for the electric utility subsidiary or subsidiaries required by this Order.

83. The provision of separate financial statements substantially enhances the Commission's ability to properly monitor and control the effects on ratepayers' rates and on the regulated electric subsidiary or subsidiaries' capital structure of WRI's affiliate transactions and WRI's corporate funding for utility and nonutilty investments. See Proctor Direct at 34. Under cross-examination, WRI witness Geist conceded that the Commission might benefit from a review of periodically filed income statements, balance sheets and cash-flow statements. Geist, Tr. at 435-36.

4. Reasons for the Requirement of Moving the KPL Utility Business to a Utility-Only Subsidiary

a. The Requirement That WRI Electric Operations Be Placed in a Separate Subsidiary or Subsidiaries Will Permit and Provide for an Allocation of Debt That Reflects Appropriate Cash Flow Needs

84. The creation of a separate subsidiary will significantly, though not completely, reduce the misallocation of debt to the electric utility activities. As already discussed, WRI is presently obligated to repay approximately $1.6 billion in debt that is related to nonutility businesses, and not utility operations. At present KG&E is a subsidiary within WRI; however, the KPL electric operations are an unincorporated component of WRI. As such, KPL operations will continue to be directly and primarily exposed to the repayment of debt and of interest expense on debt incurred for the unregulated enterprises. The relocation of the KPL operations into a separate subsidiary will permit the allocation to the new subsidiary of debt that is solely attributable to the utility's operations.

85. The Commission recognizes that utility assets may have been used to secure debt in excess of that debt attributable to utility operations -- *i.e.*, that utility assets secure debt incurred to finance nonutility activities. It is not the Commission's intent that its directive to move the KPL utility operations into a subsidiary of WRI be in conflict with such security commitments. The Commission therefore will require WRI to provide direct evidence of any such commitments, along with a narrative explanation. If the amount of WRI's consolidated debt currently secured with either WRI's or KG&E's electric utility assets exceeds the $1.5 billion of debt correctly attributable to the electric businesses, and if that excess debt must remain in the same corporation as the utility assets, then it may be necessary for the electric subsidiary or subsidiaries to hold debt in excess of the amount properly attributable to the utility

business, based on Mr. Proctor's cash flow analyses. Again, if WRI proposes such a result it must provide clear evidence of its necessity. If the necessity does not exist, then the amount of debt for which the utility subsidiary or subsidiaries is responsible should not exceed $1.47 billion attributed to it by Proctor. Proctor Direct at 14.

86. Should it be necessary for the electric utility subsidiary or subsidiaries to hold more debt than is properly attributable to it, due to a contractual requirement that debt follow assets, the Commission requires WRI to take action to assure that debt initially assigned to the electric subsidiary or subsidiaries is reduced expeditiously by that amount of debt secured by utility assets but used to fund nonutility business ventures. The record shows that such expeditious reduction in debt is possible. Specifically, the testimony of Staff witness Proctor shows that the cash flow from the electric operations is sufficient to permit at least $100 million per year to be set aside for the reduction of debt. Staff Exhibit No. JMP-17. According to the forecasted cash flow estimates presented in Staff Exhibit No. JMP-17, Schedule Nos. 2 and 3 for the years 2003 and 2004, WRI's electric utility operations will provide $344.0 million and $306.4 million cash flow from operating activities, respectively. The Commission, therefore, directs that, for the two years beginning on the date WRI submits the plans required by this Order, WRI shall reduce secured utility debt by at least $100 million per year from cash flow. At or prior to the expiration of this two-year period, the Commission will review the need for, and the measure of, continuing cash flow commitments in light of the evidence of WRI's financial condition available at that time. WRI or the electric utilities shall file quarterly reports on its progress on retiring debt secured with utility assets, beginning with the quarter ending December 31, 2002.

b. The Location of WRI's Electric Operations in Separate Corporate Entities Enhances Monitoring and Accounting for Interaffiliate Transactions

i. WRI's Current Accounting, Reporting, and Related Monitoring Are Inadequate to Protect the Interests of the Public Utility and its Customers in the Context of a Diversified Company.

87. The record in this, and related, Commission proceedings, confirms the inadequacy of WRI's accounting and recordkeeping in regard to the interaffiliate relations between electric utility and nonutility businesses.

88. Staff witness McClanahan noted that in Docket No. 01-WSRE-436-RTS, the Commission found that WRI's cost allocation manual (CAM) was inadequate for allocating costs for a company diversified in utility and nonutility business activities. That is, WRI's CAM was last revised in 1992, well prior to WRI's foray into nonutility business ventures. McClanahan Direct at 13, 15-16 and 20. Staff witness McClanahan summarized:

> Through the discovery process, parties requested WRI to provide descriptions and documentation of policies, procedures, and practices that govern the company's accounting for affiliate transactions [as contained in Attachment No. 1 to the McClanahan Direct Testimony]. The majority of these responses include only a very brief description of accounting practices and in most cases includes no documentation and supporting policies and procedures.

McClanahan Direct at 9.

89. WRI argues that recordkeeping procedures are adequate because they are kept in compliance with Generally Acceptable Accounting Principles (GAAP). However, the testimony of WRI's own external auditor, James Edwards, an accountant with Arthur Anderson, shows that GAAP does not address the concerns about interaffiliate relations that are the subject of this

proceeding. Edwards explained that in reviewing books pursuant to GAAP, auditors review financial data on a consolidated basis. They do not address allocations between or among affiliates:

> Consolidated financial statements are meant to report the financial position and results of operations of a reporting entity that comprises a parent and its consolidated subsidiaries essentially as if all of their assets, liabilities, and activities were held, incurred, and conducted by a single entity.

Edwards Direct at 11.

90. Elaborating on this distinction, Staff witness McClanahan stated that:

> cross-subsidy issues between regulated and nonregulated subsidiaries, such as assignments of assets or liabilities that may be to the detriment of the utility subsidiary, are of little or no concern to a holding company's external auditors. However, these cross-subsidy issues are very much a concern to public utility commissions.

McClanahan Direct at 7.

91. Similarly, WRI's argument that it is, or will be, subject to sufficient "corporate governance" requirements is not responsive. WRI contends that, in light of failures at Enron, WorldCom, and elsewhere "corporate governance" requirements are now imposed by statute and, therefore, WRI is already required to comply with "corporate governance" protocol. WRI Reply Brief at 42-44. However, the new corporate governance requirements WRI refers to do not address the special circumstances of regulated utilities that diversify into nonutility business ventures.

ii. The Requirement that WRI Electric Operations be Placed in a Separate Subsidiary or Subsidiaries Will Improve the Ability to Detect the Use of Electric Utility Operations to Further Nonutility Activities.

92. The separation of the jurisdictional utility operations into their own subsidiary or subsidiaries will substantially improve the Commission's ability to oversee transactions between utility and nonutility operations. With the electric utilities in their own subsidiaries, better and more timely monitoring of dealings between regulated utility and nonutility activities should be available because: (1) cash flow analyses for the regulated electric utility activities, which WRI presently states is impossible or difficult to provide for its electric businesses, would be routinely and readily forthcoming; (2) the relationship between utility operations and debt issuances will be clearer because electric subsidiaries may seek authority to issue debt directly; (3) the Commission will be able to monitor how cash transactions are recorded for accounting purposes between the electric affiliates and the holding company; and (4) the Commission will be better able to monitor operating expenses and capital investments related to activities serving utility and nonutility activities.

93. WRI argues that it cannot prepare and file periodic financial statements for the electric businesses showing cash flow, income and financial position because the electric business is not a separate legal entity. WRI states that in order to produce separate income and balance sheets for Westar Industries and WRI's electric utility businesses, "it would require certain assumptions concerning what assets comprise the electric utility business and what percent debt and interest expense should be allocated to which business at a particular point in time." WRI Initial Brief at 64. In addition, WRI argues it is not possible "to trace the money" for purposes of determining cash flow statements separately for Westar Industries and WRI's electric business. *Id.* at 66. As discussed above in Part III of this decision, WRI's arguments are not credible. However, if WRI lacks the skills or resources to compile such reports because of its present corporate structure, the corporate restructuring required by this Order will enable them

to compile such reports with the skills and resources now available. WRI's witness Geist admitted that such reports would be helpful and useful to thc Commission. Geist, Tr. Vol. 2 at 435.

94. The improved quality and availability of monitoring data means that better information will be available to those with responsibility for regulating the utility and that information is more likely to be available before damage to the utility occurs. The increased monitoring should, in turn, deter WRI management from continued efforts to use electric operations to prefer or subsidize nonutility ventures, and provide management with incentive to focus on the electric business. Finally, time and resources now devoted to overseeing WRI's continuing difficulties will be available (to the Commission and WRI management) for morc productive tasks, such as achieving excellence in all aspects of utility service.

D. Directive and Guidance on the Restructuring Plans

95. Within 90 days from the date of this Order, the Commission directs WRI to provide a plan to separate the jurisdictional electric utility business currently operating as a division of WRI into a subsidiary corporation of WRI. In connection with the filing of this plan, WRI shall file testimony which covers, at least the following issues:

1. the description of the process or procedure for the corporate restructuring, including the basis and results of the allocations of WRI's assets and liabilities to the electric utility subsidiary or subsidiaries and description of the accounting entries necessary to implement the process or procedure;
2. a statement, with documented and analytical support, as to whether the restructuring described here is consistent with WRI's present indenture agreements, and, where not consistent, what actions WRI would have to

take to obtain necessary amendments to the debt indenture agreements to proceed with the restructuring; and

3. a statement explaining how the corporate restructuring plan is consistent with the principles outlined in this Order and in the July 20, 2001 Order.

96. Any party may file comments or responsive testimony to WRI's testimony concerning its corporate restructuring plan and proposed CAM required by this Order. The Commission will determine whether a hearing and further argument is necessary upon review of the prefiled testimony.

97. The Commission understands that Sections 9 and 10 of the Public Utility Holding Company Act, 15 U.S.C. §§ 79i and 79j, will require WRI to obtain approval from the U.S. Securities and Exchange Commission (SEC) before creating the new utility subsidiary. The Commission knows of no legal reason why SEC approval of the transaction should not occur, and directs WRI to provide to this Commission, along with its plan, a draft application to the SEC. WRI's plan shall describe the steps and provisions WRI is taking to meet these requirements.

E. **WRI Shall Reduce Debt By Employing Measures Shown By the Record to Be Appropriate.**

1. **WRI Must Undertake Requisite Debt Reduction Measures, The Mix of Which the Commission Will Leave to WRI Discretion, Initially.**

98. By itself, separation of all WRI's utility businesses into an electric subsidiary or subsidiaries, along with the debt secured by those utility assets, will not eliminate fully the problems now plaguing the utility, because WRI's consolidated debt will remain excessive relative to its equity. Although much of WRI's consolidated debt will not be housed in the electric subsidiary or subsidiaries, the excess debt which today exists in WRI and which will remain, after the transfer, at the WRI level, still will affect the utility subsidiaries adversely. For example, lenders may raise the cost of debt to the electric subsidiary or subsidiaries because lenders will be concerned that debt-heavy WRI might draw funds from the electric subsidiary or subsidiaries. *See, e.g.,* Dunn Direct at 11-12. Similarly, the cost of equity to WRI will increase because the imbalance increases the financial risk for an equity investment in WRI, and thus equity holders' investment value will be diminished. Because WRI will be the source of equity for the electric subsidiary or subsidiaries (the electric subsidiary or subsidiaries do not raise equity on their own), the effect is to raise the cost of equity to the electric subsidiary or subsidiaries. While the Commission, in a rate case, may declare that excessive costs for debt and equity, arising from nonutility causes, are not recoverable in utility rates, such nonrecovery may increase financial distress. The risk is that of a vicious circle, whereby the ratemaking actions taken by the Commission to protect the utility customers from WRI's financial troubles increase those troubles, and also increase the likelihood that the customers will bear the cost of those troubles. To avoid the ratemaking dilemma, therefore, the public interest requires that the

Commission order WRI to reduce its consolidated debt while also transferring its utility business to a subsidiary.

99. The Commission is issuing these two directives -- to reduce debt and to separate all of the utility businesses into a subsidiary--to WRI, because WRI is a public utility subject to the Commission's jurisdiction, and because WRI has the excess debt which endangers that public utility. The two directives are linked: the utility business must be separated so that it no longer is subject to the debt misallocations of the past, and WRI must reduce its debt so that the dangers caused by the past decisions do not harm the utility's future. WRI, the entity subject to the Commission's jurisdiction, must take both actions. It is true that after WRI transfers its utility business to a subsidiary, WRI itself will not itself operate a public utility business. It is also true that the transfer of the public utility operations may occur before WRI has carried out the debt reduction actions required by the Commission. But because the Commission is imposing the two obligations today, on WRI in its capacity as a public utility, WRI cannot avoid its debt-reduction obligations by transferring its utility operations.

100. The record shows that WRI has a number of alternatives, which, in combination, should provide for the elimination of excess consolidated debt and the restoration of WRI to the investment grade credit rating to which its ratepayers are entitled. WRI urges, Reply Brief at Part III that its management should be permitted discretion to devise the appropriate mix of debt-reducing actions. The Commission will allow management to select the mix, subject to Commission review, so as to assure a combination of actions that is consistent with the principles and prohibitions in this Order and that will have the necessary debt-reducing effect within a reasonable amount of time. In doing so, however, WRI may not propose a form of the "rights offering" -- which the Commission has rejected twice -- because of the risk such a transaction

imposes on regulated utility activities. Moreover, the Commission's willingness to allow management to make the initial proposal, as opposed to the Commission mandating some mix of debt-reduction actions, depends on the Commission being assured, through WRI's words and actions, that there is no further conflict between the needs of the utility operations and WRI's nonutility business goals. As stated above, management is not entitled to discretion where it has the opportunity and incentive to use that discretion in a manner not consistent with the public interest.

101. Because of the dangers posed by WRI's consolidated debt, the Commission will require WRI to provide quarterly status reports beginning with the quarter ending December 31, 2002, describing the progress achieved to reduce WRI's consolidated debt. Staff shall actively monitor and review WRI's status reports.

2. WRI's Debt Reduction Measures Shall Consider and Implement those Measures Shown By the Record to Be Appropriate.

102. The record shows that the following are measures that provide feasible alternatives for the needed WRI debt reduction package. These measures must be among those considered and, with respect to the cash flow alternative discussed below, must be implemented by WRI. This obligation to consider means that if WRI rejects a particular measure, it must explain why, in the form of expert testimony.

Cash Flow. As stated herein, Staff witness Proctor demonstrated that debt can be reduced by $100 million per year from cash flow. Staff Exhibit No. JMP-17. The Commission therefore requires this debt reduction method to be employed. Specifically, WRI shall first reduce the debt assigned to the newly created electric subsidiary or subsidiaries.

Issuance of WRI Stock. The record shows that WRI can issue more shares of WRI stock to reduce consolidated debt. Proctor testified that WRI can raise funds for the purposes of reducing debt most expeditiously by issuing additional shares of WRI stock. WRI's opposition to the proposed sale of WRI stock to reduce debt is the claim that a sale of too large a volume will have negative effects on WRI's stock price. However, Staff did not propose, and the record here does not require, that the entirety of the debt reduction be made by sale of WRI shares.[6] The Commission agrees with Staff witness Proctor that an issuance of WRI common stock should be considered to generate proceeds to decrease WRI's consolidated debt. Staff's argument is persuasive that WRI's stock price increases when proceeds from the issuance of WRI common stock are used to decrease consolidated debt, and thus, decrease the current negative effect of financial distress and excessive interest expense payments on WRI's current stock price. Proctor Direct at 59-64, and Errata Filing. *See also* Staff's Reply Brief at 4. Therefore, WRI must consider the issuance of WRI stock among the alternatives.

Sale of ONEOK stock. The record shows that the sale of some or all of WRI's investment in ONEOK stock is an alternative for debt reduction. Westar Industries currently owns approximately 44.5 percent of ONEOK's stock, consisting of 7.8 percent of the ONEOK common stock and the balance in the form of convertible preferred stock. WRI Initial Brief at 8. WRI states that under a shareholder agreement between WRI and ONEOK, ONEOK or its designee has the right to purchase the stock owned by WRI at a cash sales price that is 98.5

[6] WRI, Initial Brief at 54, states that the sale of 81.4 million shares of its stock would not be practical. However, Staff used an 81.4 million figure merely to illustrate the effect of a stock sale; Staff did not advocate a sale in that amount. Rather, Staff witness Proctor testified that any WRI stock sale should be based on the "optimal combination of the issuance of WRI's common stock and the sale of part, or all, of WRI's investments in Protection One, Inc. and ONEOK, Inc." Proctor Direct at 5; *see also* Staff Reply Brief at 4.

percent of the average of the closing price of the ONEOK stock for the 20 trading days preceding the day on which the sale notice is delivered.

103. WRI's Initial Brief acknowledges that the sale of ONEOK stock is among the alternatives that should be pursued. WRI states that it intends to pursue ONEOK stock sale. WRI Reply Brief at 29-31. Thus, WRI states:

> Westar Industries currently plans to sell outright, or sell an option to purchase, all or a portion of the ONEOK stock it owns in privately negotiated transactions or sales into the public market. Under the Shareholder Agreement applicable . . . Westar Industries is now free to pursue a sale of the stock and is free of certain restrictions (including percentage limitations on sales contained in that agreement).

WRI Reply Brief at 31-32.

104. WRI explains that the Shareholder Agreement allows WRI until September 30, 2003, to complete the sale of the stock. WRI Reply Brief at 32. In sum, the record shows that the sale of ONEOK stock provides a reasonable alternative for substantial consolidated debt reduction and, therefore, WRI should pursue this among the alternatives it will consider and employ to reduce its consolidated debt.

Dividend Reductions. Staff and Intervenors (Proctor Direct at 61; Hill Direct at 24; and Dittmer Direct at 10) point out that WRI may also decrease dividends to reduce debt. WRI Initial Brief at 33, citing K.S.A. 66-1214, states that the Commission may prohibit dividends only following a hearing and requisite determination. The Commission in this Order does not prohibit WRI from making any payment of dividends; however, the Commission does direct WRI to consider the reduction or elimination (for some period) of dividends among the alternatives for a debt reduction package. If WRI does not consider or implement this measure, then WRI should include in its status report the explanation as to why it has not done so and why the Commission should not initiate a proceeding to require the electric subsidiary or subsidiaries to do so.

Sale of Protection One stock. The record shows that the sale of some or all of WRI's Protection One stock can play a significant role in the reduction of WRI's consolidated debt, especially in combination with the sale of ONEOK stock. Several witnesses explained that the sale of Protection One should be considered as part of a package with the sale of ONEOK stock. Proctor Direct at 5; Dunn Direct at 46. WRI states that the sale of Protection One is not presently desirable for a variety of reasons, including the positive outlook for Protection One. WRI Initial Brief at 30-31. WRI's arguments do not provide an adequate basis for permitting WRI to exclude consideration of a sale of Protection One stock as part of the debt reduction mix. In WRI's current financial circumstances, the question is not whether Protection One might conceivably be an attractive investment for the future; but rather, given WRI's need to reduce its debt promptly, whether the sale of part or all of Protection One is preferable to other debt reduction alternatives. To accept WRI's argument would be to accept WRI's premise: that in establishing priorities within the corporate family, favor is given to the nonutility businesses before the utility businesses. If this Order could be boiled down to one sentence, it would be a sentence rejecting that premise. WRI shall show that its proposed debt reduction steps include consideration of the relative costs and benefits of the sale of part or all of Protection One stock.

V. WRI Shall Refrain from Any Action that Results, Directly or Indirectly, in its Electric Utilities Subsidizing Nonutility Business Activities.

A. Initiation of Additional Proceedings to Determine Standards and Guidelines for Affiliate Relations within the WRI Corporate Family.

105. The corporate restructuring of WRI leaves WRI still holding a combination of utility businesses, and nonutilty businesses and investments. WRI's joint control of these two

types of business still leaves in place the risk that the utility businesses can bear risks and costs associated with the nonutility businesses. The financial and corporate restructuring discussed above therefore must be accompanied with appropriate guidelines for affiliate transactions and nonutility investments, to prevent subsidies flowing from WRI's utility business to nonutility businesses and investments that could increase electric utility rates or harm the utility's capital structure. Even with the benefits of financial and corporate restructuring required earlier in this order, there is still a need to provide better guidelines for and reporting of affiliate transactions, so that transactions that implicate or affect the regulated utility business operations meet the public interest test. WRI has argued that the Commission adopt such requirements only after a generic rulemaking procedure that applies to all jurisdictional utilities.

106. Up to this point, this Order has focused on two goals: (1) removing immediate harms or threats of harm; and (2) creating protections from additional harm. This Order sought to achieve the first goal by (a) rejecting WRI's proposed plan, which would make permanent the misallocation of debt and assets between the utility and nonutility businesses; and (b) requiring WRI to reverse those interaffiliate transactions that unjustly enriched Westar Industries' equity. This Order sought to achieve the second goal by requiring WRI to move its electric business to a subsidiary, so that, in the future, financing associated with nonutility businesses would not be incurred, backed or guaranteed by the utility business.

107. These general requirements along with the new CAM and financial reporting requirements, if implemented expeditiously and conscientiously, should shield the utility businesses from the financial harm arising from past WRI actions described in this Order and put the WRI corporate family on a path to financial stability. However, standing alone, these changes do not guarantee that cross-subsidy problems will not recur.

108. As explained in Part IV(C) of this Order, the Commission's concern that WRI's electric utility business has been used to subsidize nonutility businesses is not adequately addressed by external audits applying GAAP or the SEC filing requirements. Where utilities are part of a holding company, external auditors are primarily concerned with ensuring that consolidated financial statements are presented fairly and in adherence to GAAP. Therefore, cross-subsidy issues between utility and nonutility subsidiaries, such as assignments of assets or liabilities that may be to the detriment of the utility subsidiary, are of little or no concern to a holding company's external auditors. However, the Commission is greatly concerned with one segment of the holding company, the regulated utility operations. The cross-subsidy issues are very much a concern to the Commission, especially, where the record demonstrates that WRI has acted on incentives to enrich Westar Industries and its nonutility businesses and investments at the expense of WRI's electric utility operations.

109. To protect the electric utility operations, the Commission must determine, for example, the types and amount of nonutility investment with which the public utility can be associated; the corporate structure relationship between the utility and the nonutility business; and the types of regulatory rules and monitoring which should apply to the relationship between WRI's utility operations and its nonutility investments. The Commission will not make or impose final standards or guidelines governing affiliate relations within the WRI corporate family on the present record. Although some witnesses offered suggestions for the proper relationship between the utility and nonutility businesses, the main focus of this proceeding has been on WRI's present problems and the various plans for resolving those financial problems. The record has not been developed sufficiently for the Commission, assisted by the parties, to fashion a full policy for WRI to govern the affiliate relations between the electric subsidiary or

subsidiaries required by this Order and other WRI affiliates. Accordingly, the Commission will institute a new phase to this proceeding, which will fully address this problem. In this procceding, the parties shall address at least the questions set forth in Appendix A. Within 30 days of this order, parties shall submit to the Commission additional questions they believe should be considered. Shortly thereafter, the Commission will issue an order setting forth the final question list and a schedule for submissions.

110. While a generic rulemaking is one way to govern affiliate relations, it is not statutorily required, particularly, when there is a record replete with company-specific justification. The record in this case confirms that WRI presents such unique circumstances. The public interest requires the Commission to call upon this agency's specialized expertise in utility matters to craft appropriate guidelines and standards for affiliate relations within the WRI corporate family. While the actions the Commission directs here are subject to further review and revision in connection with any generic proceeding the Commission might initiate later, the record mandates the Commission act immediately to address the acute problems related to WRI's affiliated relations.

B. **Interim Standstill Protections**

111. The Commission must also address a remaining problem that has the potential to completely frustrate the policy objectives of this Order. During the pendency of this investigation, WRI may take further actions which increase risk to utility customers, misallocate debt and assets within the WRI corporate family or engage in interaffiliate on terms that disfavor the utility. Such actions by WRI would raise questions as to their consistency with the utility's statutory obligations to provide sufficient and efficient service and make the Commission's investigation unnecessarily difficult. The Commission cannot successfully regulate a moving

target. The Commission cannot establish proper parameters on the relationships between the utility and the nonutility businesses if WRI is simultaneously creating or modifying those relationships. The Commission therefore will establish for this interim period standstill protections to require WRI to refrain from any action that results, directly or indirectly, in its electric utilities subsidizing nonutility business activities. These activities would include, but not limited to those described below.

112. These standstill protections shall be effective immediately upon issuance of this Order, and will remain in effect for an interim period ending when the Commission adopts final guidelines and standards pursuant to the new phase of the proceeding described in Appendix A. At some point during this interim period, WRI's corporate structure will change, due to the requirement, discussed in Part IV of this Order, that WRI move its KPL utility division to a subsidiary. As explained further below, the entity or entities to which these protections apply vary, depending on whether the utility business has moved from WRI to a subsidiary.

113. For purposes of these protections, "nonutility affiliates" of WRI include Westar Industries or any subsidiary thereof, and "KPLCo" refers to the subsidiary of WRI that is the transferee of WRI's KPL utility business pursuant to the requirement of Part IV of this Order, and to any subsidiary of WRI that holds the stock of KPLCo.

Interaffiliate loans, investments and other cash transfers. WRI and KG&E shall seek Commission approval before making any loan to, investment in or transfer of cash to a nonutility affiliate of WRI from either WRI or KG&E, where the value of such transaction equals or exceeds $100,000. After the transfer of the KPL utility business from WRI to KPLCo, this requirement shall apply to both WRI and KPLCo. This requirement applies to WRI and KG&E before KPLCo comes into being, and to KPLCo and KG&E after KPLCo comes into being, so that utility resources are not inappropriately diverted to nonutility businesses. This requirement applies to WRI after KPLCo comes into being because, even though WRI at that time would not itself be a utility, its financial status could be weakened by such loans, investments and cash transfers; such weakening could raise the cost of capital for the utility subsidiary, as explained elsewhere in this order.

Interaffiliate agreements. WRI and KG&E shall seek Commission approval before either WRI or KG&E enter into any interaffiliate agreement with any WRI nonutility affiliate, where the value of goods or services exchanged exceeds $100,000. After the transfer of the KPL utility business from WRI to KPLCo, this requirement shall apply to WRI, KG&E and KPLCo. The rationale for this requirement is the same as that expressed in the final two sentences of the preceding paragraph concerning interaffiliate loans, investments and other cash transfers.

New investment in nonutility businesses. WRI and KG&E shall seek Commission approval before WRI or any affiliate thereof invests more than $100,000 in an existing or new nonutility business. After the transfer of KPL utility business from WRI to KPLCo, this requirement shall apply to WRI, KG&E and KPLCo. The rationale for this requirement is the same as that expressed in the paragraph above concerning interaffiliate loans. investments and other cash transfers.

Interest on interaffiliate loans. The outstanding balance of any existing or future interaffiliate loans, receivables or other cash advances due WRI or KG&E from any WRI nonutility affiliate shall accrue interest payable to WRI or KG&E from that debtor at an interest rate equal to the incremental cost of debt of the nonutility affiliate that is the borrower. For purposes of the preceding sentence, the incremental cost of debt is the cost of debt such nonutility affiliate would incur if it borrowed money. contemporaneously, from a nonaffiliate lender at terms and conditions comparable to those in the loan agreement between WRI and the borrowing nonutility affiliate. After the transfer of the KPL utility business from WRI to KPLCo, this requirement shall apply to WRI, KG&E and KPLCo. The rationale for this requirement is the same as that expressed in the final two sentences of the paragraph above concerning interaffiliate loans, investments and other cash transfers.

Interaffiliate asset transfers. WRI and KG&E shall not transfer or cause to be transferred, any non-cash assets, including intangible assets or intellectual property, of WRI or KG&E to Westar Industries or any WRI nonutility affiliate without Commission approval. After the transfer of the KPL utility business from WRI to KPLCo, this requirement shall apply to KG&E and KPLCo only. This requirement applies to WRI before KPLCo comes into being, and to KPLCo after KPLCo comes into being, so that utility resources are not inappropriately diverted to nonutility businesses.

Issuance of debt. WRI and KG&E shall obtain Commission approval before the issuance of any debt. After the transfer of the KPL utility business from WRI to KPLCo, this requirement shall apply to WRI, KG&E and KPLCo. The rationale for this requirement is the same as that expressed in the final two sentences of the paragraph above concerning interaffiliate loans, investments and other cash transfers.

Sale of ONEOK. If Westar Industries sells any portion of its investment in ONEOK, the requirements of Order No. 45, issued in this docket on July 9, 2002, shall apply.

114. The Commission's statutory authority, as described in Part III above, allows the Commission to govern affiliate relations within the WRI corporate family in the manner set forth in these interim standstill protections. The public utility enjoys a monopoly status which protects it from competition. That status is a privilege, not a right. While there are rights associated with

the status, such as statutory and constitutional rights to reasonable rates and to procedural due process, there is not a right to the monopoly role permanently. Nor is there a right to engage in, or to affiliate with a company that engages in, nonutility businesses which, by virtue of their type, size or actions, pose a substantial risk of harm to the utility or its customers. There is no right in the utility to act as a financier or guarantor or risk-bearer of nonutility businesses, as a trainer of future employees of or a procurer of headquarters space for a nonutility business. There is instead an obligation in the utility to refrain from activities and associations that render the utility unable to carry out its statutory obligations. These interim standstill protections assure that the utility complies with this obligation.

VI. CONCLUSION

115. A utility's statutory responsibility to the public requires focus on the utility's core obligation of servicing the public. A public utility must provide sufficient and efficient service. This means that the utility has an on-going responsibility to achieve efficiencies and remove inefficiencies. The utility must be alert to the best practices of similarly situated electric utilities and make best efforts to adopt those practices. In a competitive market, a company that does not achieve best practices loses customers to companies that do. A utility may not rely on its monopoly position to escape this type of accountability. To do so is not consistent with efficient and sufficient service.

116. The facts of this case demonstrate that nonutility investments have distracted WRI management from the core obligation of servicing monopoly customers. Further, senior management lacked knowledge or understanding of the company's important internal policies and have demonstrated an inability to work with Kansas customers, Kansas communities, creditors and regulators.

117. WRI has argued that electricity service has not failed yet, but this argument misses the point. By virtue of a grant from the state, a utility has the special privilege of providing an essential service to Kansas customers; in return for such a privilege, a utility must offer more than a promise that its service will not fail. A standard of mere non-failure would leave management free to channel surplus time and talent to matters other than providing efficiency and excellence in utility service. The premise of a natural monopoly, and the regulatory system that supports it, is that a single company will operate more efficiently as a monopoly than as a competitor. But this premise carries a risk: that the freedom from competition will cause management to take its monopoly responsibilities for granted. In this case, management has treated the monopoly business less as an obligation to maximize efficiencies, and more as a device to create value for nonutility investments. That is what has happened here.

118. WRI's argument that electricity service has not failed also ignores the distinct detriment of the company's nonutility investment in terms of the use of resources. So many individuals--Commissioners, Staff and its consultants, the parties, their lawyers and their consultants; and WRI personnel--have been forced to spend significant portions of their resources, and derivatively the resources of Kansas citizens, engaged not in the productive endeavor of improving service for utility customers but in addressing problems related to WRI's nonutility activities. This waste has occurred not because of the Commission's policies but because of WRI's behavior.

119. This Order has removed the immediate opportunities. created by WRI, to use the utility businesses to benefit the nonutility business. The Commission has also initiated a process by which the Commission will determine an appropriate relationship between WRI's utility

business and its nonutility businesses. However, Staff and intervening parties have requested a management investigation to focus on management's ability to address the problems the utility businesses find themselves in. While the record supports fully and completely a management investigation, the Commission declines to do so at this time. The Commission hopes that as result of this Order, the management will focus less on nonutility businesses and more on bringing innovation and excellence to the utility business. The Commission notes that the utility's infrastructure continues to provide electric service to over 600,000 customers and remains a stable source of revenue for the company. However, the Commission reserves the option to initiate a management investigation if and as warranted by subsequent events or information.

IT IS THEREFORE, BY THE COMMISSION ORDERED THAT:

(A) The foregoing statements, discussion and analysis are hereby adopted as findings and conclusions of the Commission.

(B) The Commission rejects WRI's Financial Plan, as amended.

(C) WRI is directed to initiate corporate restructuring in accordance with the parameters provided above and to submit a corporate restructuring plan for Commission approval along with new CAM procedures for the electric subsidiary or subsidiaries required by this Order within 90 days from the date of this Order.

(D) WRI is further directed to reverse the accounting transactions described herein and to comply with the reporting requirements and

(E) The prohibitions as set forth in the July 20, 2001 Order at Ordering Clauses (B), (C) and (D) shall remain in full force and effect until further order of the Commission.

(F) WRI shall take immediate action to reduce the excessive consolidated debt consistent with the principles discussed herein and shall provide the Commission reports addressing consolidated debt reduction on a quarterly basis beginning with the quarter ending December 31, 2002.

(G) WRI shall not take any action that results, directly or indirectly, in its regulated electric public utilities subsidizing unregulated business activities and shall abide by the interim standstill protections established herein.

(H) The Commission directs the investigation to consider standards and guidelines to govern affiliate relations within the WRI corporate family. The parties shall file comments on the list of questions set forth in Appendix A, within 30 days from the date of this Order.

(I) This Order will be served United States mail to all of the parties in this docket. A party may file a Petition for Reconsideration of this Order within fifteen (15) days, plus three (3) days for service by mail, of the date of this Order.

(J) The Commission has jurisdiction over the subject matter and the parties pursuant to K.S.A. 66-101 *et seq.* that jurisdiction is continuing over the subject matter and parties for the purpose of entering such further orders as it may deem necessary.

BY THE COMMISSION IT IS SO ORDERED.

Wine, Chr.; Claus, Com.; Moline, Com.

Dated: NOV 0 8 2002

ORDER MAILED

NOV 0 8 2002

Executive Director

Jeffrey S. Wagaman
Executive Director

Appendix A
Investigation of Utility Affiliation With Non-Utility Businesses

Rationale for the Investigation

The corporate restructuring of WRI leaves WRI still holding a combination of regulated utility businesses, and unregulated businesses and investments. The joint control of these two types of business still leaves in place the risk that the utility businesses will bear risks and costs associated with the nonutility businesses.[1] The financial and corporate restructuring discussed in Order 51 therefore must be accompanied by appropriate guidelines for the amount and type of nonutility businesses with which the utility businesses may be affiliated, as well as the type of affiliate transactions they may engage in.

Questions for the Investigation

The Commission expects its investigation to cover the questions set forth below, among others. Within 30 days of this order, parties shall submit to the Commission additional questions they believe should be considered. Shortly thereafter, the Commission will issue an order setting forth the final question list and a schedule for submissions.

The questions cover five topics: (a) new nonutility investment, (b) interaffiliate agreements, (c) issuances of debt, (d) ownership of WRI stock and (e) reports.

I. New Nonutility Investment

A. Type and Amount of Investment

[1] The equity component of the utility's capital structure can be harmed or impaired even though inappropriately but incurred costs are excluded from rates. That is, if costs incurred by the regulated electric business are not included in rates, the revenue shortfall will decrease the common equity in the capital structure.

1. Should the Commission limit the dollar amount of investment in nonutility businesses, and types of such businesses, with which the utility business may be affiliated?

2. What quantity limits should exist? (e.g., percentage of the value of utility assets, percentage of value of all affiliated assets, percentage of retained earnings in the utility or in the entire corporate family).

3. What type-of-business limits should exist? (e.g., energy-related vs. non-energy related, domestic vs. foreign, industries in which management has proven success)

B. Notification and Approval of Investment Plans

1. Should the Commission require WRI to seek Commission approval for --

   a. any new or expanded lines of nonutility business or investment ventures entered into by WRI or any of WRI's affiliates or

   b. any change or transfer of rights, obligations, or assets between or among the regulated electric subsidiaries, WRI and any of WRI's affiliates?

2. Should there be a de minimis or safe harbor exception from Commission review and approval for certain amounts or types of investment?

3. What criteria should the Commission apply in reviewing such investments?

4. As an alternative to advance approval, is it sufficient for the Commission to place no limits on investment but to require after-the-fact notice of such investments?

II. Interaffiliate Agreements

A. In General

1. Should the Commission require that any agreements between WRI and any of WRI's subsidiaries or affiliates be filed with the Commission for review and approval prior to their implementation?

2. Should there be a de minimis or safe harbor exception from Commission review and approval?

B. Loans from the Utility Business to Other Affiliates

1. With respect to loans from the utility business to other affiliates, should the Commission --

   a. prohibit them

   b. allow them up to a certain amount

   c. allow them only for certain purposes

   d. allow them subject to certain advance approvals

   e. allow them subject to certain reporting requirements, such as reporting --

      (1) the date of the transfer, the amount of the transfer, the maturity date, if any, of the transfer, and the interest earning rate on the transfer

      (2) the security provided

      (3) daily balances of borrowings for each individual borrowing

      (4) the duties and responsibilities of each cash transfer participant

      (5) the methods of calculating interest

      (6) the purpose of the loan and any restrictions on the borrower's use of the proceeds

2. How should the foregoing concepts be applied where the lender is not the utility but instead is the holding company (i.e., when KPL becomes a subsidiary of the holding company)?

C. Interaffiliate Transfers of Cash and other Assets

1. The cost allocation manual and reporting requirements described in Part IV of the Order should provide the Commission with some information concerning interaffiliate accounting practices. In light of WRI's history of improper use of utility resources to support

nonutility ventures, there is a further need for standards regarding interaffiliate transactions. Examples of standards, on which the parties can comment, appear below.

2. Dividends

a. As explained in Part IV of the Order, WRI has attributed excess debt to its utility business. Even after the KPL utility business is moved from WRI to a subsidiary, the level of debt secured by utility assets will be of such magnitude that the electric utility subsidiary or subsidiaries, at least initially, may hold debt which should be the responsibility of WRI's nonutility businesses. The Commission therefore has ordered that WRI expeditiously pay down utility-secured debt to the level correctly attributable to the regulated electric subsidiaries.

b. This need to pay down debt gives rise to several questions:

(1) Should the Commission prohibit the regulated electric subsidiary or subsidiaries from paying a dividend to WRI, except as determined under particular guidelines? Consider, for example, the following possible guidelines:

(a) When the quarterly dividend is limited: Limit the quarterly dividend for any quarter in which the combined regulated electric subsidiaries' common equity percentage for the previous quarter-ending balance sheet is less than 45 percent of total capital. (For purposes of determining this limitation, total capital would be the sum of common equity, preferred equity, long-term debt, quarterly income preferred securities, and current maturities of long-term debt and short-term debt.)

Should an exception to this type of limitation be available when the total consolidated debt level of the regulated electric subsidiaries for the immediately previous quarter-ending balance sheet falls below $1.5 billion or some other amount?

(b) Maximum dividend when limited: During quarters in which cash transfers from the regulated electric subsidiaries to WRI in the form of a dividend is limited pursuant to criteria set forth above, should the maximum cash transfers to WRI in the form of a dividend be limited to a percentage, such as 85 percent of the cash dividend payable to WRI's common equity shareholders?

(2) What facts exist to support the findings required by K.S.A. 66-1214 (relating to Commission-imposed restrictions on dividends)?

3. Cash Transfers Other Than Dividends

a. Given WRI's history of using the cash flow of the electric utility to support nonutility businesses, is it necessary to consider limits on the transfer of cash to WRI, or to any affiliate of WRI?

b. Should the Commission limit the frequency or quantity of such transfers?

c. For example, should the Commission require that a prerequisite to any loan by the electric business be that WRI shall maintain a minimum common equity percentage of, say, 30 percent of total capital in WRI's consolidated capital structure and WRI must maintain investment grade credit ratings?

d. Should the Commission require advance notice and approval of such transfers?

e. Should the Commission require that any such transfer be recorded as a a loan or receivable payable to the regulated electric subsidiary or subsidiaries. and be supported by contract documents obligating the nonutility?

4. Interest

a. Should the Commission require that the outstanding balance of loans from the regulated electric subsidiaries to either WRI, or to any WRI affiliate, accrue interest payable to the regulated electric subsidiary from the debtor at an interest rate equal to the nonutility's incremental cost of debt, comparable to what the borrower would pay to an unaffiliated lender?

5. Asset Transfers

a. What conditions should the Commission place on asset transfers from the utility business to other affiliates?

b. For example, should the Commission require

(1) advance approvals of asset transfers exceeding a particular dollar value?

(2) demonstrations that the price of the transfer meets some standard, such as the higher of market or book cost?

c. What types of assets should be subject to these or other requirements?

III. Issuances of Debt

A. Should the Commission require advance approval before debt issuances (a) by the utility subsidiaries, (b) by the chief holding company, or (c) by nonutility affiliates or their holding companies?

B. Should the Commission prohibit, limit or require advance approval of, the pledging of utility resources as security for loans obtained for nonutility purposes?

IV. Ownership of WRI stock

Assuming nonutility businesses continue to exist in the WRI corporate family,

1. Should the Commission prohibit ownership by them or by Westar Industries, of stock in WRI?

2. Should the Commission direct how they are held, whether they be owned by WRI directly or through an intermediate holding company like Westar Industries?

V. Reports

A. Affiliate Descriptions

Should the Commission require WRI to provide the Commission, annually, an explanation and description of all affiliates, their relationship to each other and to the regulated electric subsidiaries, the types of business in which they are involved, and a listing of their exact names and home office addresses?

B. Organization Charts

2. Should the Commission require WRI to maintain and file organizational charts with the Commission periodically?

3. Should these charts include:

   a. WRI, the regulated electric subsidiaries and WRI's other nonutility businesses;

   b. reporting requirements among management of WRI, utility subsidiaries and WRI's other nonutility businesses and;

   c. additional information?

C. Affiliate Transactions

1. Should the Commission require WRI to provide the Commission a periodic summary and explanation of any transactions or agreements between regulated electric subsidiaries and WRI or the regulated electric subsidiaries and any of WRI's affiliates?

2. If so, what information should be contained in these reports?

D. Affiliate Financial Statements

1. Should the Commission require WRI to provide the Commission the total market value for each nonutility investment on a periodic basis for which such investment exceeds a market value of some dollar threshold?

2. Should the Commission require WRI to provide the Commission, periodically, the balance sheet and income statement for each of WRI's nonutility affiliates having a book value of assets exceeding some minimum figure?

STATE OF MINNESOTA
BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

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

In the Matter of an Inquiry Into Possible Effects of the Financial Difficulties at Aquila, Inc. on Peoples Natural Gas Company and Northern Minnesota Utilities Company and their Customers

MPUC Docket No.:
G-007, 011/CI-02-1369

COMPLIANCE FILING

Pursuant to the Minnesota Public Utilities Commission ("Commission") Order Requiring Responses, issued on September 4, 2002, in the above entitled Docket, Aquila, Inc. ("Aquila") provides the following responses to the Commission's questions:

Questions on Corporate Structure, Finance and Related Issues

a. Provide organization charts and descriptions of the structure of Aquila (UtiliCorp) overall, U.S. Networks, and the Minnesota operations as of the end of 2001. Provide the same for those organizations as they now exist, and as proposed to be when the current restructuring is complete.

Response:

Two fundamental changes occurred in the structural organization of Aquila, Inc. (UtiliCorp United) from year-end 2001 and today:

1. The business focus shifted from a balanced strategy of merchant and global networks to a strategy of operating an integrated utility and portfolio of non-regulated merchant generation.

2. The U.S. Network business orientation changed from a centralized utility structure organized around the concept of unbundled services to each operating division to a state-focused, integrated utility concept.

These two fundamental shifts are reflected in the three sets of organizational charts in attachment A.

- Aquila, Inc.
- U.S. Networks
- Minnesota operations

However, the final organizational structure for Aquila, Inc. is dependent upon the degree of success in selling the identified non-strategic assets.

b. Provide a general description of the current organization of corporate financing activities for Aquila, subsidiaries, and divisions. Also provide specific information on:

i. How are the short-term credit, long-term debt, and equity needs and capital structure of PNG and NMU determined? How are each of these types of financing provided?

ii. How would the above change when restructuring is complete?

iii. What capital structure would be imputed/assigned to PNG and to NMU at June 30, 2002 and projected December 31, 2002?

Response:

i. Aquila has one corporate financing group located in Kansas City that provides treasury and financing support to all its North American subsidiaries and divisions. Treasury and financing services are also provided to certain subsidiaries in the international ownership structures. The core operating companies in Australia, New Zealand and the United Kingdom perform their own treasury and financing functions with input from the central group in Kansas City.

The capital structures for each of the operating divisions and subsidiaries are determined based on comparisons to other companies in similar industries. For example, comparable gas distribution companies, which mirror the operations of PNG and NMU (collectively referred to as PND on the Aquila general ledger), carry debt/equity structures of 50/50. PND's capital structure is targeted to that level on an ongoing basis and there is no plan to change this methodology. This system of capital allocation used by Aquila was detailed in the pending rate case. Therefore the ongoing capital structure is unchanged from the rate case.

As explained in the rate case, long-term debt is supplied to PNG and NMU based on need and request. All debt is assigned to the division for the life of the issue. Once a division is assigned long-term debt, that debt becomes a part of that division's permanent capital and is not reallocated or used in the financing of other divisions. The cost of the assigned debt to the division is exactly the same as the cost of the debt to Aquila, Inc.

ii. It is not anticipated that this approach would change upon completion of the restructuring.

iii. Each subsidiary or division would be assigned debt and equity according to their capital needs and their targeted capital structure. Surplus capital, if any, will be retained at the corporate headquarters and not assigned to subsidiaries and divisions.

c. Provide a general description of the current financial situation of Aquila, including debt ratings (if different than what is described in Commission Staff August 29, 2002 briefing papers) liquidity, ability to raise long-term debt and equity, and costs of capital.

Also provide specific information on:

i. What issuances and redemptions of securities are projected for the next 12 months by Aquila or other corporate financing entity?
ii. What action is Aquila management taking to mitigate the adverse impacts of credit downgrades?
iii. What would be the impact of further downgrades of Aquila debt by bond rating agencies? What types of collateral requirements or other conditions might come into play?

Response:

The rating agencies first began expressing concern regarding Aquila's credit rating earlier this year. The Company responded to these concerns by: reducing costs by about $100 million, exiting from the energy trading business, lowering the common stock dividend by 42%, issuing $800 million of equity and debt to bolster liquidity, exiting from the announced purchase of Cogentrix, and selling assets as part of a $1 billion divestiture program. The utility cost reduction actions, while included in the $100 million, were initiated as part of a restructuring plan that preceded the focus on credit quality. Over a 3–4 month period, management made these decisions and began implementation. The Company believed its reactions to the issues raised by the rating agencies were responsive, decisive and significant. In fact, as of today, Aquila has entered into sales agreements for about $786 million of assets and expects to announce another transaction over the coming weeks. Most of these asset sales are scheduled to close prior to year-end and the proceeds will be used to reduce debt. The plan developed by management results in regulated activities representing about 95% of Aquila's operations and financial metrics that are commensurate with a "BBB" rating. During the presentations to the rating agencies, management expressed its commitment to an investment grade rating and its willingness to take the actions necessary to maintain those ratings.

On September 3, Moody's downgraded Aquila to a "Ba2" with a stable outlook, citing execution risk on the asset divestiture program as a major concern. While S&P also downgraded the Company that same week to a "BBB-" from a "BBB", their actions are a welcomed offset to Moody's more severe perspective. S&P acknowledged execution risk relating to the asset divestiture program but is clearly willing to give management additional time to implement their plan. Aquila's current corporate credit ratings are:

Fitch:	BBB-, Negative Watch
Moody's:	Ba2, Stable Outlook
S&P:	BBB-, Negative Outlook

Both S&P and Fitch's ratings are considered investment grade. No additional ratings actions from either S&P or Moody's are expected until early next year, after Aquila completes its asset divestiture program and finalizes its 2002 financial results.

Depressed stock prices and lowered credit ratings are not unique to Aquila, as many other energy industry players have experienced similar misfortunes. The deterioration in Aquila's credit ratings and stock prices has impacted its marginal capital costs. The completion of earlier capital issuances and minimal needs for external capital requirements for the next 1 – 2 years helps mitigate the realization of these higher capital costs. In fact, the next US based debt maturity is not until third and fourth quarter ($250 million and $150 million, respectively) of 2004. Through the end of 2003, Aquila's major debt maturities total about $512 million, and all are outside of the United States and pertain to the Company's international investments. Approximately 60% of this balance will be repaid using the proceeds from the New Zealand and United Kingdom sales process. The remaining balances will be refinanced in the local bank markets available to those enterprises.

The impact of higher capital costs is mitigated by the fact that Aquila is not expected to be a "net borrower" over the coming months. In fact, over $1 billion in proceeds from the asset divestiture program will be used to reduce debt. These proceeds will allow Aquila to use cash to meet financing requirements including debt maturities and open market repurchases of debt. The Company's most recent debt offering ($500 million, 11 7/8%, due July 1, 2012) will be targeted for repurchase given its higher interest rate. This debt was issued amidst the high capital costs over the past few months, and is the only issuance that would negatively impact Aquila's embedded cost of debt, none of which has been allocated to PNG or NMU.

Aquila started several months ago to enhance its liquidity with the $250 million debt issuance (30-year, 7 7/8%) in January, the corporate revolver getting up-sized to $650 million in April, and the $500 million debt issuance referenced earlier. The proceeds from the debt issuances were used to repay debt maturities which had been temporarily funded with the corporate revolver.

Aquila continues to have sufficient liquidity despite being downgraded to "Ba2" by Moody's. Primary sources of liquidity include cash flow from operations, cash from asset divestitures, cash on hand, borrowing capacity under existing loan facilities, and the ability to raise additional capital on a timely basis, if required. For example, Aquila, as a precautionary step, entered into a bank facility within a five-day period, which provided $200 million of additional liquidity during a period of tight liquidity last December. Primary uses of cash and liquidity include debt maturities, capital calls, capital expenditures, and dividends. In short, the Company currently has approximately $550 million in liquidity, and demands on liquidity resulting from Moody's downgrade are estimated to total approximately $372 million. Liquidity projections under various scenarios through the end of 2003 indicate that the Company should have sufficient liquidity to fulfill capital expenditures, debt maturities, and collateral calls.

d. What obligations does Aquila have with respect to the credit facilities and other debt of its subsidiaries, partnerships, or other entities? Specifically, are there cross-default, or similar, provisions in any of the loan agreements? Does Aquila act as guarantor, endorser, surety, or other similar role with respect to its subsidiaries, partnerships, or other similar entities?

Response:

The debt at the operating companies in Australia (United Energy, Alinta Gas, and Multinet), New Zealand (UnitedNetworks), and the United Kingdom (Avon and Midlands) is non-recourse to Aquila, is not reflected in Aquila's financial statements from an accounting perspective, and is not usually imputed onto Aquila's financial statements by the rating agencies. The debt of these operating companies is not guaranteed by Aquila and does not cross-default to Aquila. The debt at the operating companies in Canada (ANC(A) and ANC(BC)) is non-recourse to Aquila but is consolidated with Aquila for accounting and credit purposes. Aquila has non-operating subsidiaries in each of these countries which have debt outstanding. This debt totals about $750 million and is guaranteed by Aquila. The guarantees usually include cross-default language since they are modeled after the covenants in Aquila's corporate revolvers. This cross-default language generally appears in any loans that are guaranteed by Aquila. However, as stated in Mike Jonagan's letter to the Commission dated August 26, 2002, "Aquila has not and will not secure debt with Minnesota utility property without receiving prior approval from the Minnesota Commission".

From time to time, on a negotiated basis, Aquila issues two types of guaranties to support debt issuances by its subsidiaries: (a) a "loan guaranty" in support of a subsidiary's borrowing or other loan arrangement and (b) a "performance guaranty" in support of a subsidiary's contractual performance obligations.

Loan Guaranties. The Federal Energy Regulatory Commission ("FERC") prohibits FERC-regulated utility companies from issuing guaranties in respect of any security (e.g., any note, stock, debenture, commercial paper, or other evidence of indebtedness) of another person. Accordingly, Aquila is prohibited from issuing loan guaranties in support of any of its subsidiaries, including Aquila Merchant Services, Inc. ("AMS"), unless Aquila first obtains FERC approval for the loan guaranty. Aquila has standing FERC approval to issue short-term loan guaranties for amounts up to $500 million in the aggregate.

Performance Guaranties. FERC does not assert jurisdiction over Aquila guaranties that are unrelated to securities, making FERC approval unnecessary for Aquila to issue performance guaranties. From time to time, a counter party of an Aquila subsidiary seeks, and Aquila issues, a guaranty for such subsidiary's contractual performance (e.g., in respect to an agreement for a power or gas purchase or sale contract).

e. What risks and potential liabilities does Aquila have with respect to Aquila Merchant Services (AMS) and any other division or subsidiary, with respect to the SEC energy trading investigation, Federal Energy Regulatory Commission (FERC) investigations, lawsuits, and similar issues?

Response:

The short answer is "none" because Aquila believes that no liability will ultimately attach to AMS, or any of Aquila's other subsidiaries, as a result of the SEC or FERC investigations or other pending lawsuits. A more detailed response follows:

Regulatory Investigation into "Wash Transaction" Trading: The SEC announced investigations in the energy industry, including Aquila, relating to transactions by which companies may have booked revenue that is misleading. Aquila has received similar inquiries for the Commodity Futures Trading Commission ("CFTC") and the Texas Public Utility Commission (the "Texas PUC"). The transactions being investigated are known as "wash-transactions" or "round-trip trades," and they involve a simultaneous purchase and sale of the same commodity at the same price for the purpose of inflating trading volumes and revenue. At the request of the FERC, Aquila has conducted a review of its trading activity for 2000 through 2001 to identify those electricity and gas trades in the U.S. portion of the Western Systems Coordinating Council that could have some of the characteristics of these sell-buyback trades. The trades identified by Aquila accounted for less that one-half of one percent of its trading and marketing revenues during this period. These trades were conducted for legitimate business purposes, such as determining market price, depth, and direction and to manage the risk of our portfolio due to changing market information. None of the trades that Aquila participated in were "wash-transactions" entered into for the purpose of increasing volumes or revenues, and Aquila's President and Chief Executive Officer Robert K. Green filed affidavits with the FERC responding accordingly. Similar responses have been filed with the CFTC and the Texas PUC, and no further action has been taken as to Aquila by either agency.

FERC Investigation into Enronean Trading Activities: In April 2002, the FERC requested that approximately 150 energy merchants, including Aquila, respond to questions relating to questionable California trading activities by Enron that were recently uncovered through the publication on internal Enron memoranda. After an internal review, Aquila believes that it has not engaged in any of the trading practices identified in the FERC inquiry or Enron memoranda, and Aquila's President and Chief Executive Officer Robert K. Green filed an affidavit with the FERC responding accordingly.

Other Material Litigation:

Chubb Indemnity Litigation: On February 19, 2002, Aquila and AMS filed a suit in United States District Court for the District of Nebraska against Chubb Insurance Group

("Chubb"), the issuer of surety bonds in support of AMS' performance under certain long-term gas supply contracts. Under the surety bonds, the insurance company could be required to pay up to $561 million. Notwithstanding Aquila's continued performance under the gas supply agreements, Chubb has demanded that Aquila replace it as the surety or, alternatively, post collateral to secure all of Chubb's obligations under the surety bond. If Chubb were to prevail, this would have a material adverse impact on Aquila's liquidity and financial position. However, Aquila believes there is no merit to Chubb's position given AMS' full compliance with the underlying gas supply contracts, and that the court will agree with Aquila's interpretation of Chubb's right to demand discharge under the indemnity agreements.

Aquila and AMS Recombination Litigation: A consolidated lawsuit was filed against Aquila and AMS in Delaware Chancery Court in connection with the recombination of Aquila and AMS that occurred pursuant to an exchange offer completed in January 2002, raising allegations concerning the lack of independent members of the board of directors of AMS to negotiate the terms of the exchange offer on behalf of the public shareholders of AMS. The Delaware Chancery Court denied the plaintiffs' claim for equitable relief in January 2002, and there has been no further activity with the lawsuit. Securities fraud complaints seeking damages based on the same conduct were recently filed against Aquila in federal court. Persons holding certificates formerly representing approximately 1.8 millions shares of AMS common stock are also pursuing their appraisal rights in connection with the recombination. Aquila does not believe that any of these actions will have an outcome materially adverse to Aquila or AMS.

f. After it exits the wholesale trading business, what obligations would Aquila have for the past activities of AMS, with respect to the issues in D and E above?

Response:

As Aquila winds down the wholesale trading business of AMS, the contracts and arrangements comprising the AMS "book of business" grows smaller each day. Aquila's obligations under the guaranties related to the contracts of AMS will persist as long as the underlying contractual obligations continue.

Aquila believes that the pending investigations and lawsuits related to AMS will result in no material liability attaching to AMS or Aquila. However, Aquila's potential liability related to such investigations and lawsuits will remain unchanged following the wind down of AMS' wholesale trading business. In this regard, it is helpful to understand that there are no plans to liquidate or dissolve the corporate entity of AMS. Instead, to reduce the risk of Aquila's overall operations, the trading and risk management businesses within AMS have been discontinued and are being shut down. AMS will retain any liabilities in respect of the company's past operations and its remaining operations going forward.

Questions about Protection of PNG and NMU Ratepayers

g. What actions are Aquila management taking to protect PNG and NMU, their ratepayers and customers from existing and potential impacts of Aquila's financial difficulties? Specifically:

i. What are the projected financing needs for P NG and NMU over the next 12 months?

ii. What action is Aquila management taking to ensure that PNG and NMU have access to needed short-term operating capital? Is Aquila willing to make a commitment that any credit capacity of PNG and NMU will not be used by Aquila for non-utility purposes?

iii. What actions are Aquila management taking to ensure PNG and NMU have access to needed long-term capital? Is Aquila willing to make a commitment that any credit capacity of PNG and NMU will not be used by Aquila for non-utility purposes?

iv. What actions are Aquila management taking to ensure that PNG and NMU will have access to needed equity?

v. What actions are Aquila management taking to assure service quality for Minnesota customers, including but not limited to: handling customer complaints, call center response time, meter reading and billing, maintenance of utility equipment and facilities, line locate requests, leak response time, new service requests, and adequate staffing levels?

vi. How will the announced staffing reductions in U.S. Network Services affect Minnesota operations? Provide employee counts by function assigned to Minnesota operations at the end of 2001, currently, and projected after restructuring is complete.

<u>**Response:**</u>

i-vi Relative to Aquila's cash generation and access to capital, PNG and NMU's capital requirements should not pose any significant challenges for Aquila. At this time, no incremental external financing needs exist for PNG and NMU as explained in question c. The Company remains committed to its regulated operations (including PNG and NMU) and will take whatever actions are necessary to support these activities. As described above, Aquila management has taken a number of steps to protect credit quality and to ensure the Company is able to raise capital when needed. While concerned, management believes that the Company has, and will continue to have, sufficient access to capital. First, the Company will be generating over $1 billion of cash from asset sales over the next three to four months, and this cash will be used to meet incremental capital requirements and to reduce debt. Second, Aquila was able to increase its corporate revolver and access the debt and equity capital markets multiple times this year, and the Company has no reason to believe that either the bank markets or capital markets are now inaccessible. Third, the non-investment grade debt capital markets in the United States had over $800 billion in debt outstanding at the end of August. The US capital markets are clearly willing and able to invest in non-investment grade companies. With its split rating (i.e. "BBB-"/"Ba2"), there is no reason to believe that Aquila will be unable to access the capital markets. And fourth, Aquila's credit situation is an improving one, and one that is strongly supported by management actions that should result in improved credit ratings. Management has clearly demonstrated its commitment to credit quality over the past few months, and will continue with that commitment until investment grade ratings with key credit agencies are restored.

Rating agencies first determine a company's overall credit rating before they assign ratings to specific issuances. Each individual issuance is then notched off of this corporate credit rating based on each issuance's structural and security attributes. Aquila has an "operating company" structure rather than a "holding company" structure. As such, Aquila's credit ratings are based on a blending of all of its activities. Absent structural and legal separation, it is not possible to segregate the impact that particular enterprises have on Aquila's overall credit capacity. However, Mike Jonagan, CEO of U.S. Utilities, submitted a letter to the Minnesota Commission on August 26, 2002, stating that:

- The Minnesota ratepayers should pay no more for debt costs than would be incurred by an investment grade utility, and
- The Commission has the authority during the ratemaking process to use a hypothetical debt structure to address debt costs higher than those of an investment grade utility, if such a case arises.

v. Mike Jonagan, CEO of U.S. Utilities, has established the goal of maintaining and improving service quality for utility customers as a top priority. Each state Operating Vice President, including Bennie Smith, Operating VP for Minnesota, will be required to submit a report on a monthly basis identifying trends and issues. The disaggregation of the consolidated utility operational metrics is currently underway and the complete internal management report should be available in 60 days. Mike Jonagan has already committed to voluntarily share this internal report with the Minnesota Commission and Staff. The current metrics that will be contained in this report include:

- Safety (i.e. lost time accidents and vehicle accidents)
- Call Center response time
- Operations leak/emergency response time
- Meter reading and billing accuracy
- Overall customer satisfaction index

vi Each Operating Vice President was asked to identify the staff required to maintain a safe and reliable utility operation that would continue to maintain high levels of customer satisfaction. Aquila is not anticipating any adverse impact from the announced staffing reductions and in fact, believes that the shift to a state focused structure and the alignment of responsibility and accountability will improve utility operations.

The change in employee counts for the Minnesota operation is as follows:

mployees by Function	Aug. 02	Dec. 01
Customer Service	156	177
Operations	49	51
Material Management	1	1
Gas Planning & Design	1	1
Safety	1	1
Technical Training	1	1
Customer Relations (sales, economic development, community services)	5	14
Environmental		1
Human Resources	1	1
IT	1	1
Governmental Services	1	1
Financial Management	1	1

The total staffing in Minnesota has been reduced from 251 to 218. However, there are currently 4 vacancies (3 in customer service and 1 in engineering/operations) so the total authorized staff is 222.

h. Does Aquila plan to ask the Minnesota Public Utilities Commission for rate relief that is in any way associated with its current financial difficulties? How does the current corporate restructuring relate to the pending Minnesota general rate case?

<u>Response:</u>

Aquila does not plan to ask the Commission for rate relief related to the financial matters addressed in these responses. The current corporate restructuring is not in any way related to the pending Minnesota general rate case. The rate case used a 2000 test year period. The current corporate restructuring would be expected to have some effect on a 2002 test year period and would likely have a greater impact on a 2003 test year period, just as other changes in expenses, investments and revenues have changed since 2000. It is inappropriate to make changes to a 2000 test year period because of isolated out-of-period changes in expenses. Rather, any evaluation of rates on a going forward basis related to 2002 or 2003 would require an evaluation of all revenues, investments and expenses.

Dated: September 18, 2002

Respectfully submitted,

By ______________________________
Michael J. Bradley

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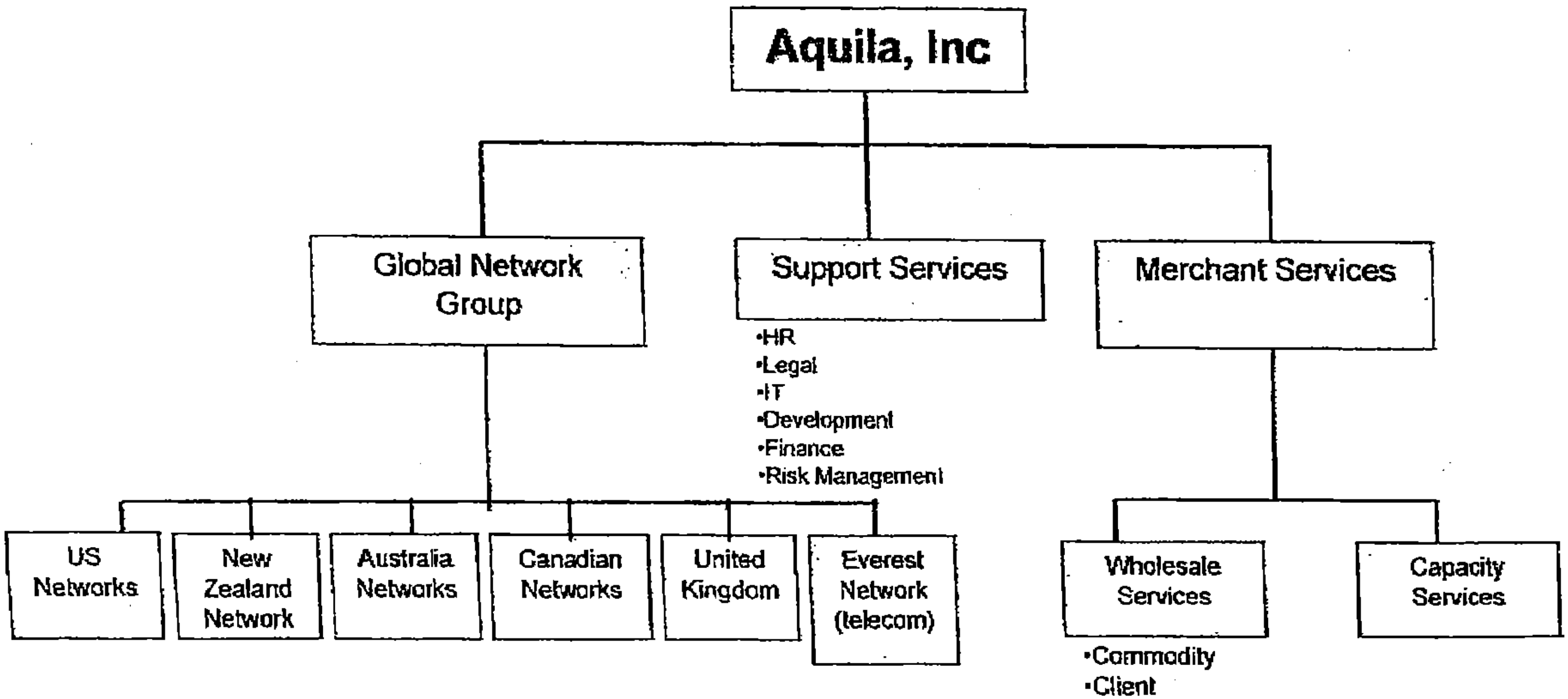
Attorneys on Behalf of Aquila, Inc.

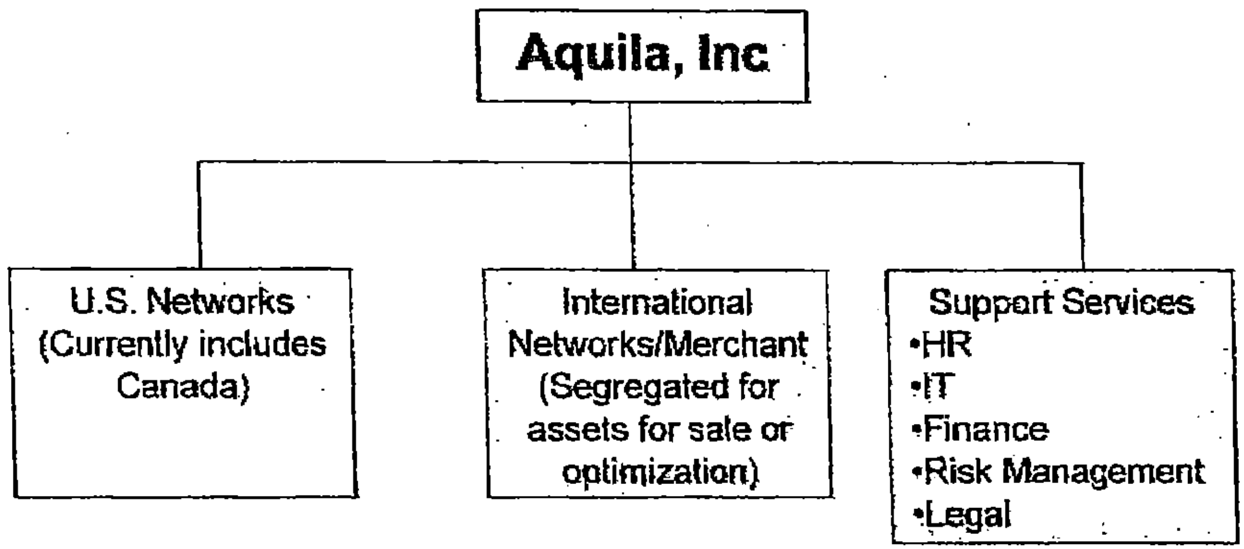
Aquila

December 2001



Aquila

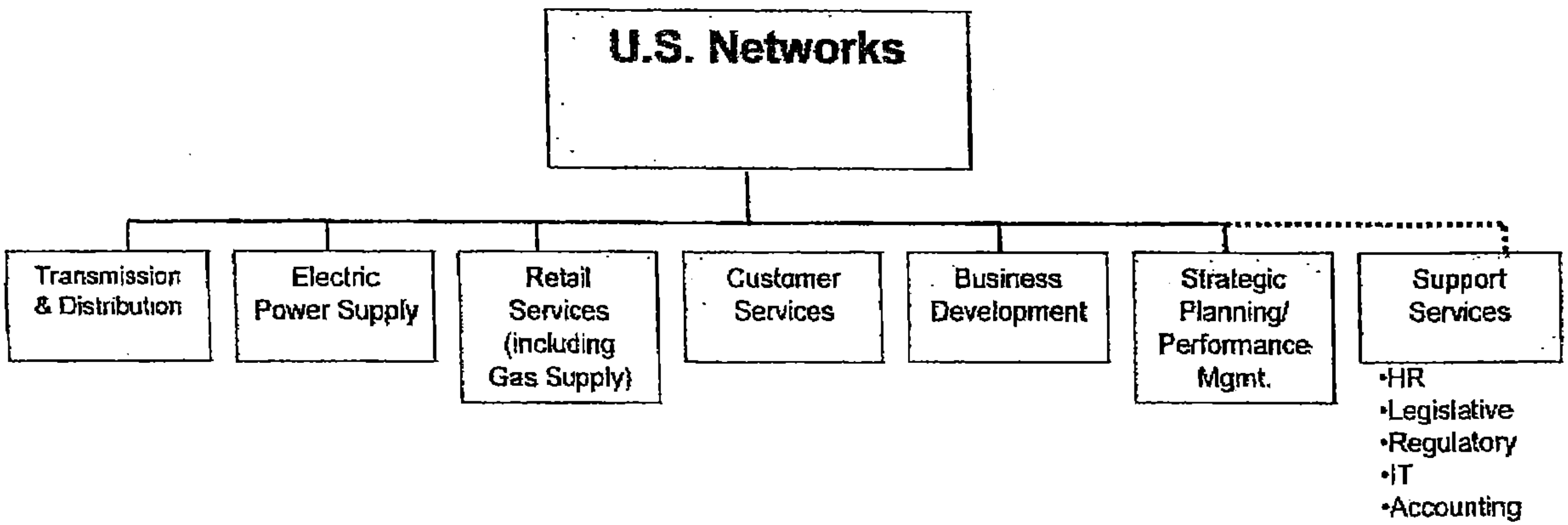
September 2002



2002 interim (final organization dependent upon asset sale success)

Aquila

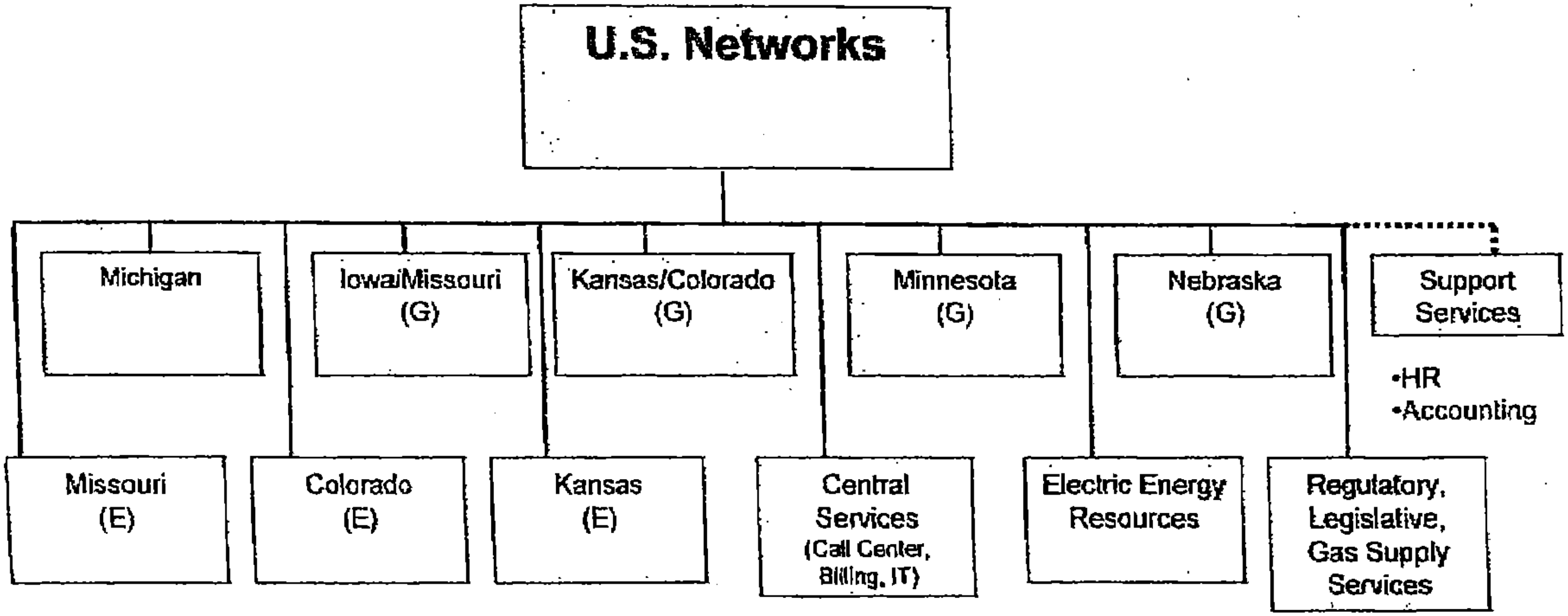
December 2001



NOTE: Personnel working in Minnesota had functional reporting relationships to the departments in Kansas City. For example, operations personnel (see Minnesota 2001 Org Chart) reported to Transmission & Distribution; sales personnel reported to Retail Services.

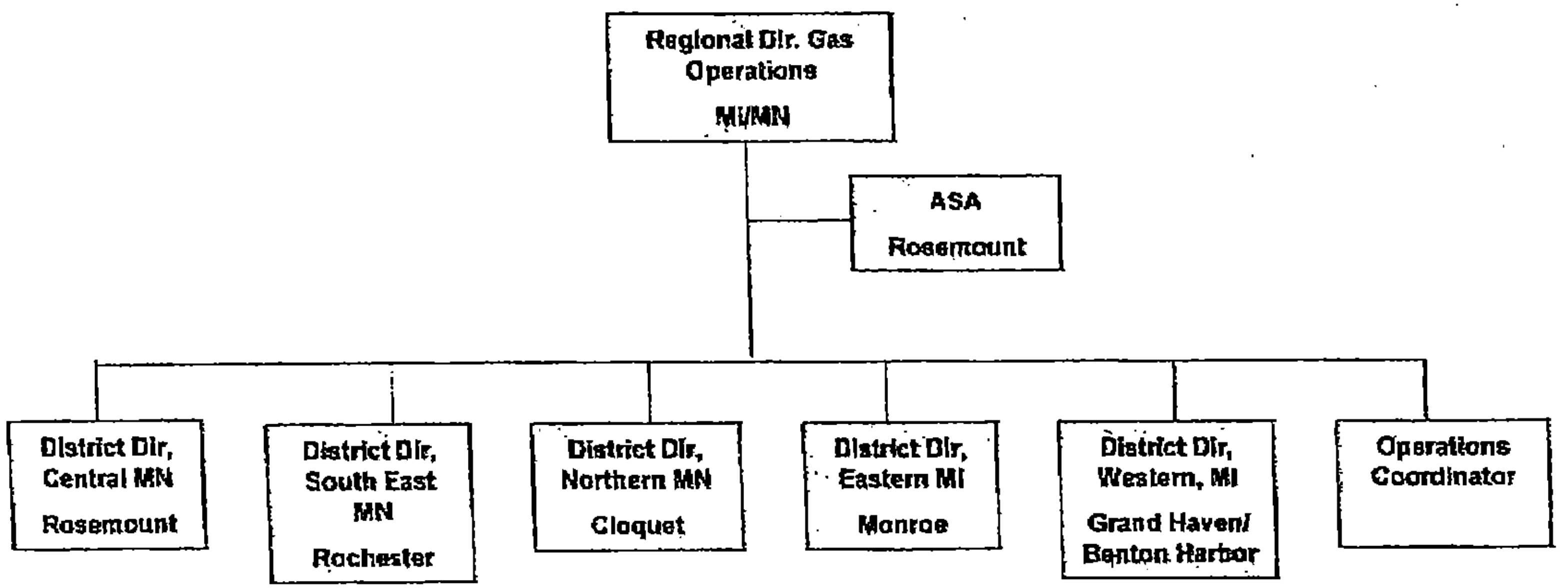
Aquila

September 2002



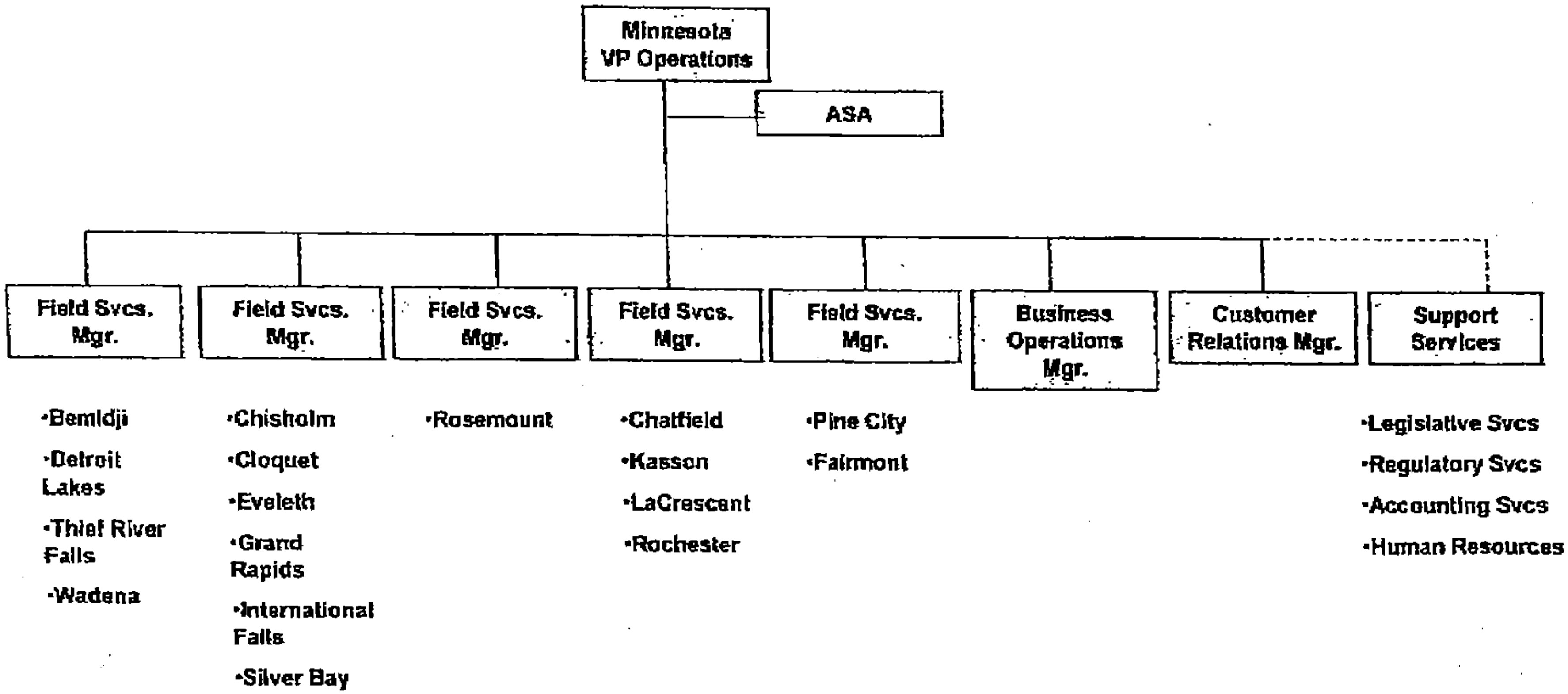
Aquila

December 2001



NOTE: A "Minnesota" organization chart does not exist for 2001, per se. The organizational structure was centralized with functional reporting to Kansas City Departments This chart covers the Customer Service and Operations personnel, which was the majority of the personnel.

September 2002



BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

COMMENTS OF THE MINNESOTA DEPARTMENT OF COMMERCE

DOCKET NO. G007,011/CI-02-1369

I. INTRODUCTION

The Minnesota Public Utilities Commission (Commission) has regulatory authority over Peoples Natural Gas Company-Minnesota (Peoples) and Northern Minnesota Utilities (NMU). The Peoples Natural Gas Company has operations in Minnesota, Iowa, Colorado, Kansas, South Dakota, Michigan, Oklahoma, Texas, and Nebraska, and NMU serves customers in Minnesota only.[1] These two utilities are operating divisions of Aquila, Inc (Aquila or the Company). The following comments on the *Inquiry into Possible Effects of Financial Difficulties at Aquila, Inc. on Peoples Natural Gas and NMU and its Customers* (Comments) discuss the potential effects of Aquila's financial concerns on the ratepayers of the Company's two Minnesota regulated operating divisions.

In the last year, the Enron Corporation's bankruptcy, accounting misdeeds of Arthur Andersen, and the California energy crisis have focused regulatory attention onto energy companies. Several investigations were undertaken by federal agencies, including the: Commodities Future Trading Commission (CFTC); Federal Energy Regulatory Commission (FERC), and the Securities and Exchange Commission (SEC). In turn, this led, in part, to companies in the energy sector experiencing a severe credit shortage. This credit shortage was, in the Department's view, due to investor and lender mistrust and caused by a perception that all energy companies were involved in some level of accounting improprieties and/or market manipulations. In addition to the plethora of problems identified above, the economy slowed down such that there was less price volatility and lower energy prices and, thus, lower earnings for energy companies.

[1] Peoples Natural Gas Company information comes from the direct testimony of Debra Keim, exhibit DAK-4 in the Company's recent Minnesota rate case, Docket No. G007,011/GR-00-951.

As a result of these events, among other investor concerns, Aquila stock dropped from a high of $33 to its current price (as of October 17, 2002) of about $4 per share. Additionally, the Company has had its senior unsecured debt rating lowered. On September 3, 2002, Moody's Investor Services (Moody's) downgraded Aquila's senior unsecured debt to Ba2, which is non-investment grade (junk) status. That same week, Standard and Poor's (S&P) downgraded the Company's senior unsecured debt to BBB- which is one step above junk status. On August 19, 2002, Fitch Ratings (Fitch) downgraded Aquila's senior unsecured debt to BBB-, one step from junk status. In an effort to regain its financial stability Aquila announced "Project BBB+/Baa1" in late spring. Three of the main components of this plan were to target $1 billion of its non-core assets for sale, cut costs by $100 million, and complete equity and debt offerings of $764 million. As of October 10, 2002, the latter two goals have been met and, Aquila reported closed or pending sales of $876 million of its non-core assets.[2]

The credit situation has eased somewhat as Aquila has aggressively taken steps to ensure its continued solvency, but certainly the Company is not completely out of danger. This report is meant to provide information to the Commission about the current state of Aquila's financial affairs and the potential impacts on Peoples' and NMU's regulated ratepayers. These comments by the Minnesota Department of Commerce (Department) are not meant to be an all-encompassing financial review or a statement of fact about Aquila's financial situation, but rather to review Aquila's potential financial issues that may affect Peoples' and NMU's Minnesota regulated ratpayers. The Department highlights six issues in this report, Aquila's:

- status as an "operating company";
- sale of non-core assets;
- low stock price;
- overall debt issues (debt ratings and cross-default);
- cost of capital issues (Peoples'-NMU's cost of capital), and;
- service quality issues and service quality measures.

II. DEPARTMENT ANALYSIS

A. *AQUILA'S STATUS AS AN "OPERATING COMPANY"*

Aquila is an operating company, which means that it directly owns operating assets. In Aquila's case, the Company owns and directly controls the distribution pipelines, metering equipment, etc. that is used to deliver natural gas to Minnesota customers.

[2] See Section B. *Aquila's Sale of Non-Core Assets* for a discussion on assets that have been sold.

There certainly are some similarities between the financial situations of Aquila and Xcel Energy (Xcel), but the first major difference is Aquila's status as an "operating" company and Xcel's status as a "holding" company. In the case of Xcel, as a "holding company" it does not own or directly control any of the utility assets, rather it owns and provides administrative support functions to its various subsidiaries, one of which is NSP-Minnesota (NSP), which is doing business as Xcel Energy.

The Department understands that NSP's regulated ratepayers may be insulated to some extent from an NRG bankruptcy, as NSP and NRG are different companies. This would not be true in Aquila's situation. In response to Commission Staff September 4, 2002, Information Request II.B.i-vi., on page 9, which was answered by Aquila on September 18, 2002, the Company states in regard to an "operating company,"

> As such, Aquila's credit ratings are based on a blending of all of its activities. Absent structural and legal separation, it is not possible to segregate the impact that particular enterprises have on Aquila's overall credit capacity.

As can be understood from this explanation, Aquila's regulated operations (Minnesota included) are intertwined with Aquila's nonregulated operations.

In order for the Department to understand the effect on Peoples and NMU in the event of a potential Aquila bankruptcy the Department issued Information Request 6, on October 4, 2002, (DOC Attachment 1). In its response to this Information Request, Aquila appears to represent that Minnesota law completely protects Minnesota ratepayers. The Company says, without further explanation,

> Aquila's Minnesota PNG and NMU operations are conducted as a division of the corporate entity Aquila, Inc. Accordingly, if Aquila, Inc. were to file for protection under the bankruptcy laws, the assets held by that corporate entity (i.e., including its divisions) would fall under the jurisdiction of the bankruptcy court. However, it is Aquila's belief that Minnesota Statute 216B.50 will continue to prohibit dispositions (in excess of $100,000) of PNG's and NMU's assets without first obtaining Commission approval. This statutory protection will operate to preserve the commission's jurisdiction over the utilities' assets for the benefit of the rate-paying customers.

The potential situation that Aquila has presented is quite disconcerting to the Department. From a legal perspective, it is not clear at this time which entity would have authority over the disposition of the sale of Aquila's Minnesota properties, a bankruptcy court or the Commission. As will be discussed further below, the Company currently has certain ratings triggers attached to some of its obligations that could potentially require the Company to pay up to $159 million to its creditors. In light of the fact that Aquila was recently obligated to pay $233 million to its creditors due to certain ratings triggers, the Company's dubious liquidity situation may be irreparably damaged if further ratings triggers necessitate additional payment.

Because of the potential bankruptcy exposure to Minnesota utility property, the Department recommends that the Commission order Aquila to provide a full and complete report to the Commission that would investigate the Company's claim that Minnesota Statute (Minn. Stat.) 216B.50 would protect ratepayers' interests in the event of an Aquila bankruptcy such that to deny the sale of Aquila assets to satisfy the Company' creditors. This report should specify the legal standing the Commission would have in a bankruptcy proceeding and protections that could be put in place to protect Peoples' and NMU's ratepayers. X

B. AQUILA'S SALE OF NON-CORE ASSETS

Aquila has proceeded with certain sales of its nonregulated operations. As of October 10, 2002, the Company has sold $876 million of its targeted $1 billion in assets sales.[3] Two recent sales included the Company's 50 percent stake in the Oasis Pipe Line Company and its 70 percent stake in UnitedNetworks Ltd.

Specifically, Aquila closed sales of its Southeast Texas and Mid-Continent natural gas pipeline systems, including natural gas and gas liquids processing assets, and its 50 percent ownership in Oasis Pipe Line Company. The Aquila pipeline facilities and other assets in this sale, owned and operated by Aquila subsidiary Aquila Gas Pipeline Corporation (AQP), included three natural gas pipeline systems, two processing facilities and eight natural gas treating facilities, all in Southeast Texas. The Mid-

[3] Aquila Asset Sales As of October 10, 2002 (Millions)	Total Proceeds
Lockport power project	$ 37.5
Natural gas pipeline and processing assets	265.0
UnitedNetworks	362.0
Texas gas storage assets (pending)	180.0
Quanta stock (open market and private sales)	13.8
Corporate aircraft	15.4
Other businesses	2.4
Total asset sales closed or pending	$876.1

Continent assets, located primarily in western Oklahoma, included AQP's Elk City natural gas and gas liquids processing plant and its associated gas gathering system. In addition to these assets, the sale also included AQP's ownership interests in two joint venture arrangements with assets located in South Texas and the Permian Basin area of West Texas. The Oasis pipeline system, which consists of some 600 miles of pipeline, connects the Waha natural gas hub in the Permian Basin of West Texas with the Katy market hub near Houston, Texas. Physical throughput capacity of the pipeline is approximately 1 billion cubic feet of gas per day (Bcf/d). In addition to these natural gas gathering and delivery assets, the Company has announced the sale of its Texas gas storage assets valued at $180 million.

On September 9, 2002, Aquila announced that it had sold its 70 percent interest in UnitedNetworks, the Company's New Zealand assets, and on October 11, 2002, announced that the sale was completed for $503 million.[4] UnitedNetworks is a network infrastructure company that owns and manages electricity, gas, and fiber optic networks. It is New Zealand's 11th largest company by market capitalization and has net assets valued at NZ$2.28 billion and annual capital expenditures around NZ$80 million. UnitedNetworks owns 30,022 kilometers of electricity lines, 7,098 kilometers of gas lines and 100 kilometers of fiber optic cable. It owns "state of the art" fiber optic networks in the Auckland and Wellington Central Business Districts, distributes electricity to around 30% of New Zealand's electricity consumers and distributes gas to around 50% of the country's gas consumers.

Additionally, on September 30, 2002, the Company announced that it had completed the sale of its 16.58 percent interest in the Lockport Energy facility. This facility is a 180-megawatt gas-fired power plant approximately 30 miles north of Buffalo, New York, in the town of Lockport. Aquila apparently is also interested in selling it Midlands Electricity properties (now Aquila Networks UK) but has stated publicly that it will only part with this property for what it deems a fair price. This asset was purchased by the Company in May, and is the fourth largest regional electric company in the United Kingdom.

1. Aquila's current nonregulated subsidiaries

Following the sales detailed above, Aquila currently has four major subsidiaries: United Energy Limited; Multinet; AlintaGas Limited; and Quanta Services, Inc. (Quanta). The first three subsidiaries are in Australia, which limits the extent of financial information that can be accessed publicly, beyond the standard Company provided financial data.[5]

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[4] Aquila's share of the net proceeds in this sale was estimated to be approximately $362 million.

[5] The Aquila website can be used to download some financial information for United Energy Limited and AlintaGas Limited. These companies are required by Australian regulations to have filings similar to SEC required 10-Q, except on a biannual instead of quarterly basis

Quanta Services' financial information has been included as a part of this report. For the quarter ended June 2002, Quanta's revenues are down, net income is negative (two quarters running), and long term debt is higher, but not significantly so when compared with the Company's debt situation in June 2000. The Compustat credit scorecard seems to show that Quanta is at the same range, A to BBB, (one step above speculative) as is Aquila.[6] (See DOC Attachment 2). As stated, however, there are three other foreign subsidiaries in Australia of which the Department has limited information.

The bottom line is that it is not clear the extent to which Aquila's nonregulated subsidiaries are contributing to the Company's financial problems. As will be discussed further in Section D. *Overall Debt Issues*, the issue is the Aquila guarantee of certain subsidiary debt. In one case, Aquila was required to make payment when its credit rating fell to non-investment status. In another case, subsidiary obligations could require further payments by the Company. (See DOC Attachment 3).

However, Aquila has endeavored to sell these non-core assets. The Company has stated its intent to return to a regulated utility, thus, if the non-core asset sales proceed, the subsidiary issue should be less important in the overall viability of the Company. It does seem rather clear, however, that a further ratings downgrade would seriously inhibit Aquila's ability to regain its financial stability.

C. *AQUILA'S LOW STOCK PRICE*

Aquila's low stock price is reflective of several legitimate issues: fluctuating earnings due to energy prices, regulatory investigations, and a large amount of debt. However, investors' perception of the Company is very important also, and perception may be based less on actual facts and more on innuendo. Aquila has been aggressively selling assets, $876 million as of October 10, 2002, to stabilize their debt situation and improve liquidity.

Aquila's higher financial risk will raise the cost of common equity for the Company. At the time of the next rate case the cost of common equity for Aquila may or may not be higher, based on the perceived financial risk of the Company at the time of the next rate case. If Aquila has returned to financial stability, the cost of common equity capital will not be higher as a result of what happened in the past. Unlike the cost of debt, the cost of equity is forward looking and does not have an imbedded historical cost. However, if Aquila is still in financial difficulty at the time of the next rate case, the cost of common equity capital may be higher at that time. If this is the case, Minnesota ratepayers should be protected from this higher cost of common equity capital.

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[6] It has been rumored that Aquila is trying to sell its 38 percent interest in Quanta.

D. *Overall Debt Issues (Debt Ratings and Cross-Default)*

a. Debt Ratings

In terms of the Company's financial status, for the period ended June 2002, revenues are up but its net income shows a loss of $810 million.[7] Long term debt is higher compared with the Company's June 2000 situation, but not significantly. The Compustat credit scorecard shows Aquila's credit grade at the A to BBB long-term date rating range. This is one step above speculative, at which Fitch and S&P have rated the Company's senior unsecured debt. In sum, based on the financial information provided and obtained and the Company's business performance, as assessed by Compustat, there appear to be reasons for the Company's current near speculative debt rating. (See DOC Attachment 4).

The long-term debt issue of Aquila and its subsidiaries is not as dire as Xcel/NRG's current situation. However, two issues are relevant to this debt discussion: Aquila's current debt rating and its existing cross-default provisions.

As to debt rating, in response to Commission Staff Information Request I.C.i-iii., on page 3, Aquila states,

> On September 3, Moody's downgraded Aquila to a 'Ba2' with a stable outlook, citing execution risk on the asset divestiture program as a major concern. While S&P also downgraded the Company that same week to a 'BBB-' from a 'BBB', their actions are a welcomed offset to Moody's more severe perspective. S&P acknowledged execution risk relating to the asset divestiture program but is clearly willing to give management additional time to implement their plan.

The current Aquila senior unsecured bond ratings are:

Fitch:	BBB-, Negative Watch (one step from non-investment grade)
Moody's:	Ba2, Stable Outlook (non-investment grade)
S&P:	BBB-, Negative Outlook (one step from non-investment grade)

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[7] Due in large measure to one-time costs Aquila absorbed in the second quarter, including: "Restructuring charges" and "Impairment charges." This information is from Aquila's 10-Q filing of August 14, 2002, page 4.

The Company does not expect any ratings actions until early next year. This means that Aquila will have some time to continue its asset sale, pay down debt, and resolve some of its regulatory issues. Of course, the low ratings raise Aquila's cost of capital and can make it difficult to borrow. These issues will be discussed further in Section E. *Cost of Capital Issues* below.

b. Cross-Default

A major impact of the low ratings, however, as with Xcel/NRG, is the cross-default provisions that Aquila has in place. Commission Staff Information Request I.D. specifically asked,

> What obligations does Aquila have with respect to the credit facilities and other debt of its subsidiaries, partnerships, or other entities? Specifically, are there cross-default, or similar, provisions in any of the loan agreements?

In its response to Commission Staff Information Request I.D., page 5, the Company states,

> The debt at the operating companies in Australia (United Energy, AliantGas, and Multinet), New Zealand (UnitedNetworks), and the United Kingdom (Avon and Midlands) is non-recourse to Aquila, is not reflected in Aquila's financial statements from an accounting perspective, and is not usually imputed onto Aquila's financial statement by the ratings agencies. **The debt of these operating companies is not guaranteed by Aquila and does not cross-default to Aquila.** (Emphasis added.)

The Department is concerned that Aquila's statements to the Commission are contradicted by the information the Company provided in its SEC 10-Q form dated August 14, 2002 (DOC Attachment 5). In this, Aquila states on page 18 under the heading "Ratings Trigger" that,

> Certain of our subsidiaries have trigger events tied to specific credit ratings. Because of guarantee and cross default provisions between Aquila, Inc. and these subsidiaries, the ratings triggers of our subsidiaries discussed below should be viewed as if they are directly applicable to Aquila, Inc. Our Australian subsidiaries have issued six series of Australian denominated bonds,

> guaranteed by us, that contain provisions that could require us to repurchase the bonds. The put right for two series aggregating approximately $85 million can be exercised 30 days after a downgrade to non-investment grade by either S&P or Moody's. Those series mature in October 2002. The put right for the other four series aggregating approximately $92 million can be exercised on the next scheduled interest payment date if we are rated below investment grade by S&P.
>
> Our Merchant Services subsidiary also has three 'tolling agreements,' a construction loan and certain margining agreements that have trigger events tied to Aquila's credit ratings. Under the tolling agreements, our subsidiary uses a third party's generation assets to convert fuel into electric power for its subsequent resale. The maximum aggregate amount of collateral that it could be required to post in the event of a ratings trigger under these contracts is approximately $172 million. Of this amount, $45 million must be posted within 10 days of a downgrade below investment grade by either Moody's or S&P; $37 million must be posted within 70 days of the date we are rated below investment grade by both Moody's and S&P; and $28 million under the construction loan must be posted within 10 business days of a downgrade below investment grade by both S&P and Moody's.

On October 4, 2002, the Department issued Information Request 8 (DOC Attachment 6) to clear up this seeming contradiction. In its October 11, 2002, response to this Information Request the Company stated,

> The debt referenced on page 18 of our 10-Q refers to Australian debt Aquila guarantees and consolidates onto its financial statements. The proceeds from these debt offerings were used to fund Aquila's' 'equity investments' into the underlying utility operating companies (i.e., Alinta Gas, United Energy, and EPG/Multinet). Equity distributions from these utility operating companies is used to service and repay Aquila's debt borrowed in the local currencies. The debt of the utility operating companies is not supported by Aquila or consolidated on its financial statements. The

> statements in the 10-Q and our earlier response are not inconsistent.

From the Department's reading of the information provided in information requests and the Company's 10-Q filing, Aquila has not accurately represented its cross-default situation to the Commission. For example, in response to Department Information Request 7 (DOC Attachment 3) the Company provides information in detail on the $233 million of Australian debt, Tolling and Margining Agreements, and Commodity Contracts the Company has had to repay since Moody's downgraded its debt rating to junk status. Further, this Information Request details that an additional $159 million may be required if S&P should downgrade Aquila's debt rating.[8] These "capital calls" have siphoned almost a quarter of a billion dollars from Aquila, right when the Company is in its most dire financial position.[9] It is at best disingenuous for the Company to say to the Commission that "[T]he debt of these operating companies is not guaranteed by Aquila and does not cross-default to Aquila."

Aquila has guaranteed debt and has been forced to repay the Australian issuance, and other costs, due to the Company's debt rating downgrade by Moody's. There exist other potential triggers that could take effect. It appears that Aquila was not forthright in response to Commission Staff Information Request I.D.

Additionally, the letter of August 26, 2002 letter from Mike Jonagan, Chief Executive Officer (CEO) of U.S. Utilities, to the Commission cited in the Company's response to Commission Staff Information Request I.D., on page 5, appears to mislead in its intent to assuage the Commission's fears of Aquila's Minnesota utility property being liquidated to pay off the Company's debts. According to Aquila's response to Department Information Request 6, the Commission's only recourse in an Aquila bankruptcy would be Minn. Stat. § 216B.50. The fact that this statute would protect Minnesota ratepayers is not at all certain. The Jonagan letter states that "Aquila has not and will not secure debt with Minnesota utility property without receiving prior approval from the Minnesota Commission." As discussed above, however, the debt of Aquila is the debt of Peoples and NMU, and thus, all of Aquila's debt is secured with all of the Company's properties, including the Minnesota utility property.[10]

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[8] Currently, S&P has Aquila's long term debt rated one step from junk status.

[9] Aquila is currently involved in a lawsuit that could potentially cost the Company $561 million. Aquila Merchant Service sold long term gas contracts to certain Nebraska municipalities and had the Federal Insurance Company (Chubb Insurance Group) issue surety bonds in support of these contracts. Chubb has demanded that Aquila replace it as the surety or, alternatively, post collateral to secure all of Chubb's obligations under the surety bond. On February 2, 2002, Aquila filed suit against Chubb's (case #802CV3059) to avoid replacing Chubb or to post collateral. The case has recently been moved to the US District Court in Kansas City, Missouri.

[10] This letter seems to have been sent less to ease tension about the Company's financial situation and more to be in response to any concern some party may have that the Company violated Minn. Stat. §

The Company has been less than forthright with the Commission about its current debt situation and the exposure of its Minnesota regulated operations to the Company's tenuous financial condition. Above, the Department recommended that the Commission order the Company to author a report that would explain specifically the Company's claim that Minn. Stat. § 216B.50 would protect ratepayers' interests and give the Commission discretion over the potential selling of Aquila assets to satisfy the Company's creditors. This report may begin to answer some of the Department's concerns.

E. COST OF CAPITAL ISSUES (PEOPLES-NMU COST OF CAPITAL)

The cost of debt of Peoples and NMU is the cost of debt to Aquila. The capital structures of both Peoples and NMU are based on comparisons to other companies in similar industries such as comparable gas distribution companies, which mirror the operations of Peoples and NMU. The current capital structure for Peoples and NMU is roughly 50/50 debt to equity. This system of capital allocation was proposed by Aquila in its most recent rate case (Docket No. G007,011/GR-00-951). The Department agreed that this method was reasonable.[11] This is one of the primary links between Aquila and Peoples/NMU as Aquila borrows all the money for the financial needs of Peoples and NMU and then allocates the borrowed funds to each division based on need. The cost of the assigned debt to the division is exactly the same as the cost of the debt to Aquila.

In response to Commission Staff Information Request II.B i-vi., on page 8, Aquila states,

> Relative to Aquila's cash generation and access to capital, PNG and NMU's capital requirements should not pose any significant challenges for Aquila. At this time, no incremental external financing needs exist for PNG and NMU as explained in question c.

The Company in another response to Commission Staff Information Request I.C. i-iii., on page 4, states that its higher capital costs are not an issue to PNG and NMU because, ["T]he impact of higher capital costs is mitigated by the fact that Aquila is not expected to be a 'net borrower' over the coming months."

216B.49, subdivision 3. This statute prevents a utility from specifically encumbering Minnesota utility property "for the purpose of securing the payment of any indebtedness" without prior Commission approval. As discussed above, Minnesota property was not specifically used to secure any credit facilities, but if Aquila cannot make payments on its debts, the Company's Minnesota property would be subject to a potential bankruptcy court. Although Aquila did not pledge Minnesota property to secure debt, the practical effect may be the same as if the Company had.

[11] Direct Testimony and Exhibits of Eilon Amit, page 26, lines 9-16.

The Department interprets both these statements to mean that Peoples and NMU can pay the operational costs of each utility and service the cost of each utility's debt with the cash generated internally. In response to Commission Staff Information Request II.B.i-vi., on page 8, the Company discusses further the steps that it has taken to ensure access to credit, for each utility should it be needed, such as increasing its corporate revolver.

The Company has stated that it directly assigns the cost of debt to either Peoples or NMU based on the requested needs from each utility. Therefore, a higher cost of debt for Aquila, due to its debt ratings downgrades discussed earlier, is directly passed to Peoples and NMU's regulated Minnesota customers in each utility's capital structure when debt is assigned to either utility. At the time of the next rate case, each utility's capital structure, which may include the current higher cost of debt to Aquila, will be used to determine the Company's Rate of Return (ROR). The ROR is one component that makes up the non-gas margin rate that Minnesota regulated customers pay for each Mcf of gas used. Thus, higher capital costs would be reflected in Minnesota regulated customers' rates if Aquila assigned this higher cost debt to either Peoples or NMU, consequently, the need for regulatory vigilance.

However, the Company has also stated that it does not foresee any capital infusion needed at either Peoples or NMU. Nevertheless, the Department wants to ensure that the cost of Aquila's financial problems is not passed onto regulated Minnesota ratepayers.

As a related issue, during the course of this investigation, the Department discovered that Aquila has not made a Capital Structure filing since 1998.[12] The Department is aware that Aquila completed a debt issuance ($500 million, 11 $^7/_8$%, due July 1, 2012) this summer. It is the Department's understanding that the Commission must approve all such issuance. Therefore, the Department recommends that as part of its Reply Comments, the Company should explain why it did not file for Commission approval of its most recent debt issuance. Further, Aquila should provide a list of the dates and amounts of all issuance since the Company's last Capital Structure filing in 1998 and a discussion of why the Company did not file for approval, per Minn. Stat. § 216B.49.

Thus, as to the issue of ratepayer protection from higher capital costs, the Department recommends that:

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[12] *A Petition by UtiliCorp United, Inc. for Minnesota Public Utilities Commission Certification to Invest in a Foreign Utility.* Docket No. G007,011/S-98-682.

- In Aquila's next rate case, the Company would identify all issuance of debt and associated cost from January 1, 2002, until its next rate case in a manner that will facilitate a potential adjustment to mitigate impacts of adverse market factors caused by Aquila's financial problems. Specifically, the Company must provide information sufficient to allow the Commission to evaluate what Peoples' and NMU's debt and equity costs would be but for the effects of its other operations;

- The Company provide a discussion and analysis in its next rate case of the effects at that time of Aquila's financial situation on Peoples' and NMU's cost of common equity;

- Aquila should report any significant financial event for Aquila and provide copies of any report made to the SEC or any other federal agency from now on; and

- In its Reply Comments, the Company should explain why it did not file for Commission approval of its most recent debt issuance. Further, Aquila should provide a list of the dates and amounts of all issuance since the Company's last Capital Structure filing in 1998 and a discussion of why the Company did not file for approval, per Minn. Stat. § 216B.49.

F. *SERVICE QUALITY ISSUES AND SERVICE QUALITY MEASURES*

It is well known that Aquila has eliminated some staff positions to save money and, at the same time, the Company reorganized each operating unit to focus on a state-by-state level. Aquila states in its response to Commission Staff Information Request II.B.vi, on page 9, on the impact of the layoffs to Minnesota operations,

> Each Operating Vice President was asked to identify the staff required to maintain a safe and reliable utility operation that would continue to maintain high levels of customer satisfaction. Aquila is not anticipating any adverse impact from the announced staffing reductions and in fact, believes that the shift to a state focused structure and the alignment of responsibility and accountability will improve utility operations.

The Company reduced staff levels for the Minnesota operations from 251 to 218 people, the "Customer Service" area experienced the largest portion of the layoffs, going from 177 employees to 156.[13] However, no explanation is offered as to what these employees currently do and why this area would be able to afford the greatest amount of layoffs. The Department is concerned with the Company's service quality on a going-forward basis, in light of the Company's many financial difficulties and the recent downsizing of its Minnesota operations. This is of particular concern in light of the Company's implicit representation in its current rate case that costs reflecting personnel staffing are reasonable at pre-staff reduction levels.

Service quality is a key concern for customers, and as such the Department has recommended that NSP and CenterPoint Energy Minnegasco (CenterPoint) have approved service quality standards that can be measured to ensure customer service. By ensuring that Aquila has similar quality standards it is hoped that the Company's Minnesota customers should not be harmed due to current layoffs, since Minnesota regulated customers are paying for the larger number of employees in their rates.

Therefore, the Department recommends that the Commission require Aquila to file a proposed gas service quality standards plan (including information on how service quality response times will be traced through regulated operations) similar to those required of NSP in merger Docket No. E,G002/PA-99-1031 within thirty days of the *Order* in this docket and begin using these mechanisms on a going-forward basis to gauge customer service quality. The Company's results should be filed quarterly. These standards should protect Minnesota customers from potentially eroding customer service and allow the Department and the Commission to monitor and compare the service quality of Minnesota's three largest natural gas providers, NSP, CenterPoint, and Peoples/NMU.

III. CONCLUSION AND RECOMMENDATIONS

Certainly the financial situation at Aquila concerns the Commission and the Department. This analysis was undertaken as a means to attempt to assess the level of financial difficulty and the extent to which regulated Minnesota ratepayers potentially could be affected by the situation.

The Company has taken aggressive steps to improve liquidity and remove debt from its balance sheet. Although these measures have, as of yet, failed to improve the Company's debt ratings, Aquila's long term strategy seems to offer the Company the best route to financial security and continued viability. However, the Department

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[13] "Customer Service" has the greatest current number of employees, 156 out of 218

continues to have concerns which center on protecting ratepayers in the short run from a potential Aquila bankruptcy, and protecting ratepayers in the long run from higher capital costs, and the potential for service quality erosion caused by the Company's financial difficulties and staff reductions.

1) As to ratepayer protection from a potential Aquila bankruptcy, the Department recommends that the Commission order Aquila to: provide a full and complete report to the Commission that would investigate the Company's claim that Minnesota Statute 216B.50 would protect ratepayers' interests in the event of an Aquila bankruptcy such that to deny the sale of Aquila assets to satisfy the Company' creditors. This report should specify the legal standing the Commission would have in a bankruptcy proceeding and protections that could be put in place to protect Peoples' and NMU's ratepayers.

2) As to the issue of ratepayer protection from higher capital costs, the Department recommends that:

- In Aquila's next rate case, the Company identify all issuance of debt and associated cost from January 1, 2002, until its next rate case in a manner that will facilitate a potential adjustment to mitigate impacts of adverse market factors caused by Aquila's financial problems. Specifically, the Company must provide information sufficient to allow the Commission to evaluate what Peoples' and NMU's debt and equity costs would be but for the effects of its other operations;

- The Company provide a discussion and analysis in its next rate case of the effects at that time of Aquila's financial situation on Peoples' and NMU's cost of common equity;

- Aquila should report immediately any significant financial event for Aquila and provide copies of any report made to the SEC or any other federal agency from now on; and

- In its Reply Comments the Company should explain why it did not file for Commission approval of its most recent debt issuance. Further, Aquila should provide a list of the dates and amounts of all issuance since the Company's last Capital Structure filing in 1998 and a discussion of why the Company did not file for approval, per Minn. Stat. § 216B.49.

3) Finally, as to the potential for a decreased level of service, the Department recommends that the Commission require Aquila to: file a proposed gas service quality standards plan (including information on how service quality response times will be traced through regulated operations) similar to those required of NSP

in merger Docket No. E,G002/PA-99-1031 within thirty days of the *Order* in this docket and begin using these mechanisms on a going-forward basis to gauge customer service quality. The Company's results should be filed quarterly. These standards should protect Minnesota customers from potentially eroding customer service and allow the Department and the Commission to monitor and compare the service quality of Minnesota's three largest natural gas providers, NSP, CenterPoint, and Peoples/NMU.

/jd

State of Minnesota
DEPARTMENT OF COMMERCE

Utility Information Request

Docket Number: G007,011/CI-02-1369 Date of Request: October 4, 2002

Requested From: Aquila, Inc. Response Due: October 10, 2002

Analyst Requesting Information: Marcus Gross

Type of Inquiry:

[ ].....Financial	[ ].....Rate of Return	[ ].....Rate Design
[ ].....Engineering	[ ].....Forecasting	[ ].....Conservation
[ ].....Cost of Service	[ ].....CIP	[ ].....Other:

If you feel your responses are trade secret or privileged, please indicate this on your response.

Request No.	
6	How are the Peoples' Natural Gas-Minnesota and Northern Minnesota Utilities' assets insulated from a potential bankruptcy of Aquila, Inc. Please provide a detailed explanation.

Response:

Aquila's Minnesota PNG and NMU operations are conducted as a division of the corporate entity Aquila, Inc. Accordingly, if Aquila, Inc. were to file for protection under the bankruptcy laws, the assets held by that corporate entity (i.e., including its divisions) would fall under the jurisdiction of the bankruptcy court. However, it is Aquila's belief that Minnesota Statute 216B.50 will continue to prohibit dispositions (in excess of $100,000) of PNG's and NMU's assets without first obtaining Commission approval. This statutory protection will operate to preserve the commission's jurisdiction over the utilities' assets for the benefit of the rate-paying customers.

Response by: ______________________ List sources of information:

Title: ______________________ ______________________

Department: ______________________ ______________________

Telephone:

Print All Sheets

Company Quarterly Debt Structure Overview

ITA SERVICES INC 713-629-7600
Post Oak Blvd Ste 2100
n TX 77056

Report generated: 9/30/2002
Ticker: PWR
SIC: Electrical Work

Exchange: New York Stock Exchange
Stock Ownership Publicly Traded Company
GICS Sub Industry Construction & Farm Machinery & He

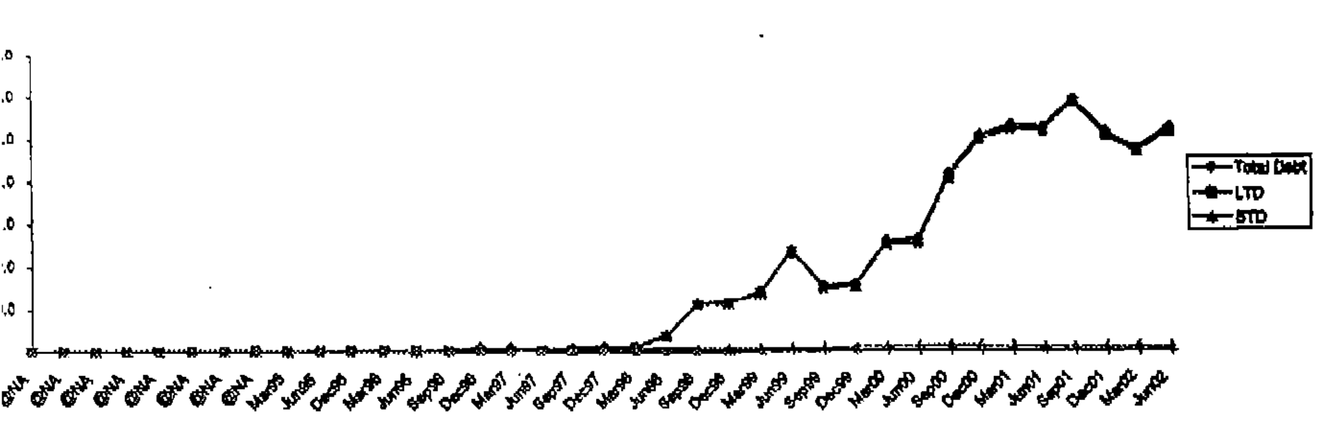
Structure	$ Amount	% of LTD
ata as of:	*Dec01*	
bt Senior	0	0.0%
bt Subord	172.5	33.7%
nvertible	172.5	33.7%
usted Debt	0	0.0%
	225.425	44.1%
res	0	0.0%
Long Term	109.33	21.4%
se Oblig	1.082	0.2%
Debt Disc & Prem	0	0.0%
ortgage & Secured	335.837	65.7%
d to Prime	109.33	21.4%
ent Liab Guarantees	@NA	#VALUE!
ta as of:	*Jun02*	
rly Debt	518.7829	101.6%
rm Qtrly Debt	511.1929	100.0%
Current Liabilities	7.59	1.5%

Officers Names
John R Colson
Chairman, Chief Executive Officer
James H Haddox
Chief Finance Officer, Secretary
Derrick A Jensen
Vice President, Controller

Qtrly Growth Rates	1 Year	3 Year
Revenues	-14.1%	30.7%
Net Income	@NC	@NC
Total Debt	-0.4%	30.2%
Curr Debt	-3.0%	10.9%
Shr's Eqty	-48.7%	14.8%
Tot Liab	-6.5%	32.5%

Market Information	
Qrtly data as of:	Jun02
Market Capitalization	592.8
Dividend Yield	0.0%
Price/Book	1.0
Shares Outstanding	61.409
Available for Interest	(176.726)
Fixed Chg Coverage:	
Before Tax	(21.995)
After Tax	(21.053)
LTD/Com Equty	86.33%
LTD/Shrhldr's Eqty	86.33%
LTD/Total Assets	86.33%
STD/LTD	1.48%
LT S&P Issuer Rating	
Subord Debt Rating	
ST S&P Issuer Rating	
S&P Stock Ranking	

rterly	Revenue	Net Income	Interest Expense	Long Term Debt	Current Debt	Total Liabilities to Assets	Debt to Capital	Debt to Shr's Equity	Curr Debt Tot Debt	YOY Total Debt	YOY Liabilities Growth	Financial Leverage
Jun00	423.5	31.1	6.4	251.7	9.0	34.0%	20.99%	26.6%	3.5%	10.9%	39.5%	1.52
Sep00	487.8	40.7	6.9	401.1	11.4	40.2%	28.16%	39.2%	2.8%	169.2%	111.7%	1.58
Dec00	548.2	14.4	7.6	491.1	8.8	43.0%	31.48%	45.8%	1.8%	218.4%	99.9%	1.63
Mar01	519.0	28.3	9.2	516.8	8.9	43.0%	31.37%	45.7%	1.7%	105.5%	65.5%	1.68
Jun01	503.3	16.7	9.1	513.3	7.8	43.0%	30.78%	44.5%	1.5%	99.9%	78.4%	1.74
Sep01	504.5	26.3	9.0	578.9	8.3	43.6%	32.77%	48.8%	1.4%	42.4%	33.4%	1.76
Dec01	488.0	13.5	8.7	500.3	8.1	40.9%	29.31%	41.5%	1.6%	1.7%	3.9%	1.74
Mar02	449.2	(435.2)	7.9	482.6	7.3	39.5%	27.45%	37.8%	1.5%	-10.6%	-6.8%	1.72
Jun02	432.5	(177.2)	8.0	511.2	7.6	57.9%	46.33%	86.3%	1.5%	-0.4%	-6.5%	1.80
@NA	@NA	@NA	@NA	@NA	@NA	@NA	@NA	@NA	@NA	#VALUE!	#VALUE!	@NA
Dec95	@NA	@NA	@NA	@NA	@NA	@NA	@NA	@NA	@NA	#VALUE!	#VALUE!	@NA
Dec96	42.7	0.8	0.6	2.1	5.0	62.8%	21.2%	26.9%	70.5%	#VALUE!	#VALUE!	@NC
Dec97	49.1	2.3	0.8	3.8	5.1	60.2%	26.3%	35.7%	59.0%	23.8%	18.6%	2.59
Dec98	309.2	15.2	4.6	109.6	3.8	49.2%	38.1%	64.3%	3.3%	1201.7%	987.2%	2.00
Dec99	925.7	53.9	15.2	199.7	6.7	34.7%	20.9%	26.4%	3.2%	82.0%	144.6%	1.81
Dec00	1,783.3	105.7	25.7	491.1	8.8	43.0%	31.5%	45.9%	1.8%	142.3%	98.8%	1.66
Dec01	2,014.8	85.8	36.1	500.3	8.1	40.6%	29.3%	41.5%	1.6%	1.7%	3.9%	1.72



QUANTA SERVICES INC
TICKER: PWR
Latest FY: Dec01
CURRENT RATING AS OF: 30Aug02
S&P LT ISSUER CREDIT RATING

S&P LONG TERM ISSUER CREDIT RATING RATIOS
Industry Comparisons

* To change company, invoke the Run

Select Industry Comparison by:

GICS Group [Capital Goods]

Rating	# of Cos. 123	Long Term Debt % of Total Capital Min	Avg	Max	Pretax Interest Coverage x Min	Avg	Max	Cash Flow Interest Coverage x Min	Avg	Max
AAA	1	57.1	57.1	57.1	25.5	25.5	25.5	27.0	27.0	27.0
AA	5	6.9	18.6	26.4	3.7	16.8	25.8	9.5	17.8	22.5
A	25	0.0	33.4	66.8	0.0	12.1	109.2	1.6	13.2	109.2
BBB	33	0.2	38.1	54.6	(6.2)	3.6	26.1	(0.5)	5.1	38.2
Speculative	59	4.7	72.3	227.2	(13.3)	0.6	6.7	(8.0)	1.3	6.8
In Default	0	@NC	@NC	@NC	@NC	@NC	@NC	@NC	@NC	@NC
QUANTA SVC			29.3			5.4			5.6	

@NC = Not Calculable

Rating	# of Cos. 123	Cash Flow % of Long Term Debt Min	Avg	Max	Asset Turnover x Min	Avg	Max	Equity Book Value/ Book Value of Liabilities Min	Avg	Max
AAA	1	26.6	26.6	26.6	0.3	0.3	0.3	0.1	0.1	0.1
AA	5	50.6	121.5	218.5	0.8	1.2	2.0	0.4	1.1	2.2
A	25	7.6	113.2	1,134.9	0.0	1.0	2.7	0.2	1.1	14.0
BBB	33	(11.1)	271.5	8,043.9	0.5	1.1	2.6	0.3	0.7	1.8
Speculative	59	(1,562.9)	(26.1)	98.0	0.4	1.1	3.1	(0.4)	0.3	1.0
In Default	0	@NC	@NC	@NC	@NC	@NC	@NC	@NC	@NC	@NC
QUANTA SVC			33.0			1.0			1.4	

Rating	# of Cos. 123	Return on Total Capital % Min	Avg	Max	Operating Income % of Sales Min	Avg	Max	Total Liabilities % of Tangible Net Worth Min	Avg	Max
AAA	1	10.1	10.1	10.1	22.1	22.1	22.1	1,899.5	1,899.5	1,899.5
AA	5	5.5	10.0	17.6	5.1	13.5	23.6	50.3	175.3	278.5
A	25	(3.2)	7.6	32.6	(8,825.6)	(339.8)	21.0	(4,045.3)	593.6	12,927.5
BBB	33	(13.6)	3.1	11.8	2.8	11.8	28.3	(9,159.7)	(361.8)	2,329.6
Speculative	59	(212.6)	(8.8)	25.2	(3.8)	9.8	38.2	(8,787.9)	(466.8)	7,966.8
In Default	0	@NC	@NC	@NC	@NC	@NC	@NC	@NC	@NC	@NC
QUANTA SVC			5.0			14.5			492.5	

State of Minnesota
Department of Commerce

Utility Information Request

Docket Number: G007,011/CI-02-1369 Date of Request: October 4, 2002

Requested From: Aquila, Inc. Response Due: October 10, 2002

Analyst Requesting Information: Marcus Gross

Type of Inquiry: [ ]....Financial [ ]....Rate of Return [ ]....Rate Design
[ ]....Engineering [ ]....Forecasting [ ]....Conservation
[ ]....Cost of Service [ ]....CIP [ ]....Other:

If you feel your responses are trade secret or privileged, please indicate this on your response.

Request No.	
7	On page 18 of Aquila's August 14, 2002, 10-Q filing certain "Ratings Triggers" are discussed. Please provide a complete listing (and description) of the ratings triggers that could occur in the next year. Provide a dollar amount that would be associated with each trigger that could be initiated.

Response:

Following is a summary of the potential capital calls listed in the 10-Q and an update of the capital calls actually made of the Company:

POTENTIAL CAPITAL CALLS

	Moody's Downgrade	If S&P Also Downgrades	Total
Australian Debt	$65	$92	$177
Tolling & Margining Agreements	$172	$0	$172
Commodity Contracts	$135	$0	$135
	$392	$92	$484

Response by: ____________________ List sources of information:

Title: ____________________ ____________________

Department: ____________________ ____________________

ACTUAL CAPITAL CALLS MADE TO DATE (w/ Moody's Downgrade)

	Possible Calls	Actual Calls	Possible Additional Calls
Australian Debt	$85	$85	$0
Tolling & Margining Agreements	$172	$113	$59
Commodity Contracts	$135	$35	$100
	$392	$233	$159

Most of the capital calls related to the Moody's downgrade of the Company have already been made and reflected in the above chart. If S&P were to downgrade Aquila to non-investment grade, then about US$92 million of Australian debt could be put to Aquila. Also, we would expect some of the Commodity Contracts that did not seek capital calls when Moody's downgraded the Company to seek collateral upon an S&P downgrade.

Response by: ____________________ List sources of information:

Title: ____________________ ____________________

Department: ____________________ ____________________

Company Quarterly Debt Structure Overview

rint All Sheets

A INC 816-421-6600
h St
City MO 64105-1704

Report generated: 9/30/2002
Ticker: ILA
SIC: Electric & Other Serv Comb

Exchange: New York Stock Exchange
Stock Ownership Publicly Traded Company
GICS Sub Industry Multi-Utilities & Unregulated Power

tructure	$ Amount	% of LTD
ta as of:	*Dec01*	
x Senior	@NA	#VALUE!
x Subord	@NA	#VALUE!
vertible	3.7	0.1%
rted Debt	@NA	#VALUE!
	@NA	#VALUE!
e	@NA	#VALUE!
ng Term	@NA	#VALUE!
e Oblig	@NA	#VALUE!
Debt Disc & Prem	0	0.0%
rtgage & Secured	@NA	#VALUE!
to Prime	@NA	#VALUE!
nt Liab Guarantees	@NA	#VALUE!
s as of:	*Jun02*	
y Debt	3531.9	128.3%
m Qtrly Debt	2752.2	100.0%
urrent Liabilities	779.7	28.3%

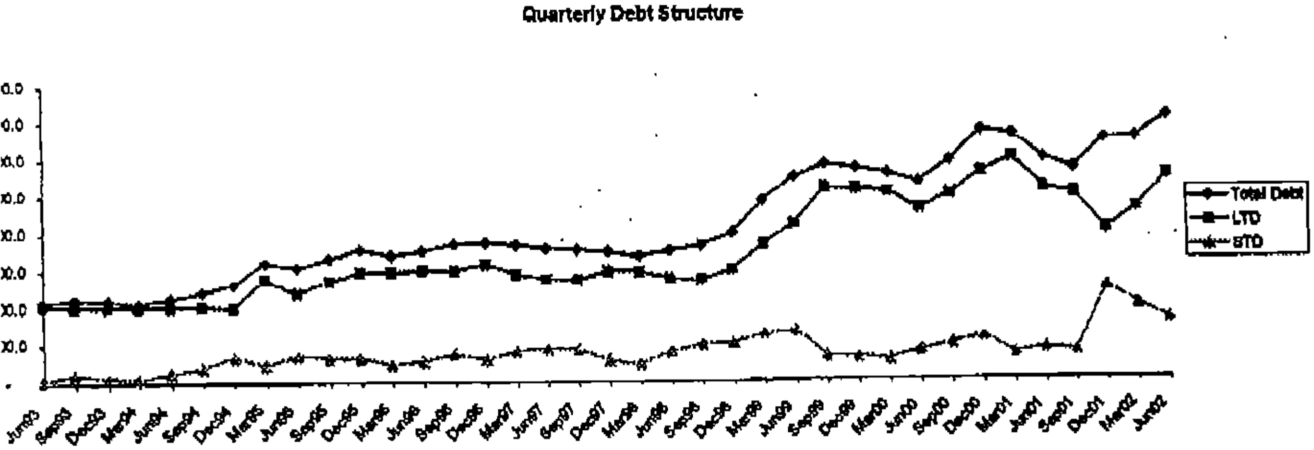
Officers Names
Richard C Green
Chairman
Robert K Green
President, Chief Executive Officer
Leslie J Parrette
Senior Vp, General Counsel
Dan Streek
Chief Financial Officer

Qtrly Growth Rates		
		Year
Revenues	-7.5%	34.5%
Net Income	@NC	@NC
Total Debt	18.5%	8.1%
Curr Debt	97.0%	6.8%
Shr's Eqty	-8.4%	16.3%
Tot Liab	-9.9%	21.6%

Market Information	
Qrtly data as of:	Jun02
Market Capitalization	1137.5
Dividend Yield	15.0%
Price/Book	0.5
Shares Outstanding	142.673
Available for Interest	(828.500)
Fixed Chg Coverage:	
Before Tax	(15.667)
After Tax	(14.312)
LTD/Com Equity	116.18%
LTD/Shrhldr's Eqty	116.18%
LTD/Total Assets	116.18%
STD/LTD	22.06%
LT S&P Issuer Rating	BBB
Subord Debt Rating	
ST S&P Issuer Rating	Satisfactory (A2)
S&P Stock Ranking	Above Average (A-)

Quarterly	Revenue	Net Income	Interest Expense	Long Term Debt	Current Debt	Total Liabilities to Assets	Debt to Capital	Debt to Shrhld's Equity	Curr Debt to Tot Debt	YoY Total Debt	YOY Liabilities Growth	Financial Leverage
Jun00	5,760.9	29.3	49.1	2,282.5	367.9	82.7%	60.06%	150.4%	13.9%	-2.5%	36.2%	5.36
Sep00	7,998.9	74.9	44.3	2,490.1	454.3	84.4%	61.45%	159.4%	15.4%	1.7%	21.3%	5.56
Dec00	10,606.0	48.2	47.3	2,795.9	552.7	87.3%	60.60%	155.4%	16.5%	17.7%	104.8%	6.38
Mar01	11,980.0	73.4	55.0	2,976.0	325.7	83.6%	57.50%	138.4%	9.9%	16.9%	84.9%	6.55
Jun01	10,441.4	143.2	50.4	2,584.1	395.7	80.4%	48.54%	99.9%	13.3%	12.4%	46.7%	6.23
Sep01	8,315.5	69.0	46.6	2,489.6	346.1	78.0%	47.21%	95.1%	12.2%	-3.7%	9.2%	5.72
Dec01	8,639.9	(6.2)	42.6	1,997.9	1,227.7	78.6%	42.44%	78.3%	38.1%	-3.7%	-23.7%	5.07
Mar02	8,861.3	44.4	44.2	2,281.0	969.2	74.0%	41.67%	71.6%	29.8%	-1.6%	-18.4%	4.51
Jun02	9,654.3	(810.0)	52.9	2,752.2	779.7	80.2%	53.70%	116.2%	22.1%	18.5%	-9.9%	4.48
Dec94	1,514.6	94.4	102.3	976.9	321.2	70.0%	50.4%	104.8%	24.7%	20.0%	13.8%	3.39
Dec95	2,798.5	79.8	113.4	1,455.4	303.7	75.0%	60.0%	149.8%	17.3%	35.5%	33.7%	3.78
Dec96	4,332.3	105.8	128.7	1,570.7	277.7	74.9%	55.9%	132.8%	15.0%	5.1%	20.9%	4.08
Dec97	6,926.3	122.1	128.4	1,458.6	263.4	77.2%	54.4%	125.4%	15.3%	-6.6%	12.2%	4.23
Dec98	12,563.4	132.2	123.7	1,475.8	484.4	75.9%	48.0%	102.0%	24.7%	13.8%	15.1%	4.25
Dec99	18,621.5	160.5	170.2	2,552.3	281.7	78.8%	61.4%	167.3%	10.3%	45.1%	32.3%	4.55
Dec00	28,974.9	206.8	184.1	2,795.9	552.7	87.3%	60.6%	155.4%	16.5%	17.7%	104.8%	6.51
Dec01	40,376.8	279.4	194.6	1,897.9	1,227.7	78.6%	42.4%	78.3%	38.1%	-3.7%	-23.7%	5.89

Quarterly Debt Structure



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* AQUILA INC
TICKER: ILA
Latest FY: Dec01
CURRENT RATING AS OF: [illegible]
S&P LT ISSUER CREDIT RATING: BBB

S&P LONG TERM ISSUER CREDIT RATING RATIOS
Industry Comparisons
Select Industry Comparable By:
GICS Group [Utilities]

* To change company, [illegible]

Rating	# of Cos. 243	Long Term Debt % of Total Capital Min	Avg	Max	Pretax Interest Coverage Min	Avg	Max	Cash Flow Interest Coverage Min	Avg	Max
AAA	0	@NC	@NC	@NC	@NC	@NC	@NC	@NC	@NC	@NC
AA	9	17.2	37.5	50.3	2.5	4.7	7.6	3.0	5.4	9.6
A	89	17.8	49.4	92.1	(1.3)	3.3	9.4	0.6	4.2	9.5
BBB	116	12.4	52.4	80.8	(5.0)	2.9	8.6	0.0	3.8	9.1
Speculative	25	24.0	58.8	86.3	0.4	2.5	6.1	1.3	3.0	5.4
In Default	4	28.3	56.9	97.2	(0.8)	2.0	3.2	(0.1)	2.3	3.4
AQUILA INC			42.4			3.7			3.8	

@NC: Not Calculable

Rating	# of Cos. 243	Cash Flow % of Long Term Debt Min	Avg	Max	Asset Turnover Min	Avg	Max	Equity Book Value/ Book Value of Liabilities Min	Avg	Max
AAA	0	@NC	@NC	@NC	@NC	@NC	@NC	@NC	@NC	@NC
AA	9	16.9	46.8	123.2	0.4	0.7	1.0	0.4	0.5	0.8
A	89	(2.5)	26.6	82.2	0.2	0.5	1.4	0.0	0.5	1.4
BBB	116	(5.6)	23.9	92.3	0.1	0.6	3.1	0.1	0.4	1.1
Speculative	25	2.5	17.7	65.2	0.2	0.5	1.8	0.1	0.4	1.1
In Default	4	(9.0)	22.2	40.1	0.3	0.9	2.0	0.0	0.4	1.1
AQUILA INC			27.6			3.1			0.3	

Rating	# of Cos. 243	Return on Total Capital % Min	Avg	Max	Operating Income % of Sales Min	Avg	Max	Total Liabilities % of Tangible Net Worth Min	Avg	Max
AAA	0	@NC	@NC	@NC	@NC	@NC	@NC	@NC	@NC	@NC
AA	9	3.7	7.6	12.2	8.0	17.2	25.2	127.2	213.6	424.2
A	89	(9.7)	5.2	12.0	5.8	24.9	64.4	(47,823.9)	(191.1)	8,222.6
BBB	116	(34.3)	4.5	14.6	(12.7)	23.0	95.5	(7,679.9)	186.4	3,707.4
Speculative	25	(3.2)	4.6	29.2	2.9	30.2	77.7	(312.9)	465.6	1,350.7
In Default	4	(14.0)	2.3	13.6	2.8	19.0	32.3	(26,336.3)	(6,166.8)	891.6
AQUILA INC			5.9			1.7			368.3	

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AQUILA INC filed this 10-Q on 08/14/2002.

. As of August 12, 2002, our senior unsecured long-term debt ratings, as assessed by the three major credit ncies, were as follows:

Agency	Rating	Levels above non-investment grade
Standard & Poor's Corporation (S&P)	BBB	Two
Fitch Ratings (Fitch)	BBB-	One
Moody's Investor Service (Moody's)	Baa3	One

credit ratings were placed under review for possible downgrade by S&P on April 23, 2002, and by Moody's 0, 2002. The reasons given by the ratings agencies included our announced acquisition of Cogentrix Energy, ciated with our foreign investments, concerns that we lacked the financial resources to support our energy erations and an analysis of our operations under more stringent credit metrics. Since that time we have taken ing actions:

Terminated the Cogentrix acquisition;

Reduced our dividend by 42%;

Exited from wholesale energy trading;

Targeted over $1 billion in asset sales in which we have signed sale agreements totaling $218 million and publicly announced bid processes for the sale of our investments in UNL and Midlands. In addition, we have active bid processes for a number of other assets;

Completed equity and debt offerings totaling $764 million in proceeds;

Targeted over $100 million in cost reductions, the majority of which have already been achieved.

management is currently in discussions with representatives of Moody's, S&P and Fitch. However, we cannot e actions, if any, that may be taken by the credit rating agencies subsequent to these meetings.

riggers

credit agreements, debt instruments and other financial obligations provide that the occurrence of certain uld (if not cured) require early payment, additional collateral support or similar actions. These events include e to achieve leverage ratios, insolvency events, defaults on scheduled principal or interest payments, on of other financial obligations and a change of control. We are currently in compliance with covenants or visions relating to these events. We do not have any trigger events tied to our stock price and have not any transactions that require us to issue equity based on our credit ratings or other trigger events.

ain of our subsidiaries have trigger events tied to specified credit ratings. Because of guarantee and cross ovisions between Aquila, Inc. and these subsidiaries, the ratings triggers of our subsidiaries discussed below viewed as if they are directly applicable to Aquila, Inc. Our Australian subsidiaries have issued six series of n denominated bonds, guaranteed by us, that contain provisions that could require us to repurchase the bonds. ight for two series aggregating approximately $85 million can be exercised 30 days after a downgrade to non-nt grade by either S&P or Moody's. Those series mature in October 2002. The put right for the other four gregating approximately $92 million can be exercised on the next scheduled interest payment date if we are ow investment grade by S&P.

Merchant Services subsidiary also has three "tolling agreements," a construction loan and certain margining ts that have trigger events tied to Aquila's credit ratings. Under the tolling agreements, our subsidiary uses a a party's generation assets to convert fuel into electric power for its subsequent resale. The maximum aggregate ount of collateral that it could be required to post in the event of a ratings trigger under these contracts is roximately $172 million. Of this amount, $45 million must be posted within 10 days of a downgrade below estment grade by either Moody's

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AQUILA INC filed this 10-Q on 08/14/2002.

$37 million must be posted within 70 days of the date we are rated below investment grade by both Moody's ; and $28 million under the construction loan must be posted within 10 business days of a downgrade below nt grade by both S&P and Moody's. We expect the trigger under the construction loan will terminate upon the on of construction and permanent project financing in late September 2002. We also have certain standard g agreements that would require collateral of $62 million if we were downgraded below investment grade. tential collateral requirements are expected to decline as we exit the wholesale energy trading business over :wo months.

otential Demands for Collateral

ough we are in the process of exiting the energy trading operations of our Merchant Services subsidiary, a al number of energy trading agreements remain to be settled. The majority of these contracts will be settled e next two months. These contracts typically include provisions which allow counterparties the right to request l collateral or suspend or terminate credit if events occur that cause counterparties to feel that there has been a tion in our underlying credit. In connection with our exit from the wholesale energy trading business, we have l key commercial relationships that will be important to our ongoing business. If a downgrade were to occur, ationship companies could potentially demand collateral support for ongoing and future activity. While it is o predict how many parties would successfully demand some form of collateral, we currently estimate that the f cash collateral would be no more than $135 million. We expect that potential claims on liquidity will be duced as we exit our wholesale energy trading business over the next two months.

oceeding

February 19, 2002, we filed a suit against Chubb Insurance Group, the issuer of surety bonds in support of our long-term gas supply contracts. Previously, Chubb had demanded that it be released from its up to ion surety obligation or, alternatively, that we post collateral to secure its obligation. We do not believe that entitled to be released from its surety obligations or that we are obligated to post collateral to secure its is unless it is likely we will default on the contracts. Chubb has not alleged that we are likely to default on the If Chubb were to prevail, it would have a material adverse impact on our liquidity and financial position. We ormed under the contracts since their inception and believe we will be able to continue to perform on the and that we will prevail in the action. We rely on other suretys in support of long-term gas supply contracts those described above. There can be no assurance that these suretys will not make claims similar to those Chubb.

e Taxes

second quarter 2002 income tax benefit was reduced primarily as a result of two factors: First, the tax benefit $692.9 million pre-tax write-down of our investment in Quanta Services is limited to available capital gains in ding three years and subsequent five years. Because capital gains within the carryback period were less than nd significant capital gains could not be assured in the foreseeable future, a $201 million valuation allowance lished. Second, the $178.6 million impairment charge related to Wholesale Services goodwill is considered a t difference between book and taxable income and does not result in the recognition of a tax benefit. These its have had a significant impact on the 2002 effective tax rate for both the quarter and six months ended 2002.

ction of Dividend

une 17, 2002, we announced that, going forward, our Board of Directors expected to reduce the quarterly to $.175 per share, or $.70 per share annually, down from the prior quarterly dividend of $.30 per share, or share annually. This decision was made in connection with our decision to scale back the wholesale energy isiness and was influenced by, among other things, decreased earnings, a substantial increase in the number of ng shares, and the Company's credit concerns. On August 7, 2002, our Board of Directors declared a dividend per share. The record date for the dividend is August 22, 2002, and the dividend is payable on September 12,

State of Minnesota
DEPARTMENT OF COMMERCE

Utility Information Request

Docket Number: G007,011/CI-02-1369 Date of Request: October 4, 2002

Requested From: Aquila, Inc. Response Due: October 10, 2002

Analyst Requesting Information: Marcus Gross

Type of Inquiry:

[ ]......Financial	[ ]......Rate of Return	[ ]......Rate Design
[ ]......Engineering	[ ]......Forecasting	[ ]......Conservation
[ ]......Cost of Service	[ ]......CIP	[ ]......Other:

If you feel your responses are trade secret or privileged, please indicate this on your response.

Request No.	
8	Please reconcile the information on page 18 of Aquila's August 14, 2002, 10-Q filing ("Ratings Triggers") with the Company's response to Commission Staff's Information Request No. 1.D. filed on September 18 where the Company states, "The debt of these operating companies is not guaranteed by Aquila and does not cross-default to Aquila."

Response:

The debt referenced on page 18 of our 10-Q refers to Australian debt Aquila guarantees and consolidates onto its financial statements. The proceeds from these debt offerings were used to fund Aquila's "equity investments" into the underlying utility operating companies (i.e., Alinta Gas, United Energy, and EPG/Multinet). Equity distributions from these utility operating companies is used to service and repay Aquila's debt borrowed in the local currencies. The debt of the utility operating companies is not supported by Aquila or consolidated on its financial statements. The statements in the 10-Q and our earlier response are not inconsistent.

Response by: ______________________ List sources of information:

Title: ______________________ ______________________

Department: ______________________ ______________________

Telephone:

STATE OF MINNESOTA)
) ss
COUNTY OF RAMSEY)

AFFIDAVIT OF SERVICE

I, **Kathy Aslakson,** being first duly sworn, deposes and says: than on the **22nd** day of **October, 2002,** served the attached **Minnesota Department of Commerce Comments**

DOCKET NUMBER: G007,011/CI-02-1369

XX by depositing in the United States Mail at the City of St. Paul, a true and correct copy thereof, properly enveloped with postage prepaid
XX by personal service (MN PUC)
by express mail
by delivery service

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

see attached service list

Kathy Aslakson

Subscribed and sworn to before me

this 22nd day of October, 2002

Karen L Santori

KAREN L. SANTORI
NOTARY PUBLIC - MINNESOTA
MY COMMISSION EXPIRES
JANUARY 31, 2005

G007,011/CI-02-1369

In the Matter of Peoples Natural Gas
and NMU Inquiry into Possible effects
of Financial Difficulties at Aquila,
1 Service List

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Bill Blazer
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In the Matter of Peoples Natural Gas
and NMU Inquiry into Possible effects
of Financial Difficulties at Aquila,
1 Service List

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Energy CENTS Coalition
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St. Paul, MN 55106

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30 East Seventh Street
St. Paul, MN 55101

MOSS & BARNETT

A Professional Association

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90 South Seventh Street
Minneapolis, MN 55402-4129
Telephone 612.347.0300
Facsimile 612.339.6686
www.moss-barnett.com

MICHAEL J. BRADLEY
612.347.0337
BradleyM@moss-barnett.com

November 1, 2002

HAND DELIVERED

Dr. Burl Haar
Executive Secretary
MN Public Utilities Commission
121 Seventh Place E, Suite 350
St. Paul, MN 55101

RE: *In the Matter of an Inquiry Into Possible Effects of the Financial Difficulties at Aquila, Inc. on Peoples Natural Gas Company and Northern Minnesota Utilities Company and their Customers*
MPUC Docket No. G-007,011/CI-02-1369

Dear Dr. Haar:

Enclosed for filing in your office please find the original plus 15 copies of the Aquila Reply Comments in the above-referenced docket, together with an Affidavit of Service.

Please contact the undersigned if further information is needed.

Very truly yours,

MOSS & BARNETT
A Professional Association

Michael J. Bradley

MJB/krm
Enclosures
cc: Service List
534983/1

AFFIDAVIT OF SERVICE

STATE OF MINNESOTA)
) ss
COUNTY OF HENNEPIN)

In the Matter of an Inquiry Into Possible Effects of the Financial Difficulties at Aquila, Inc. on Peoples Natural Gas Company and Northern Minnesota Utilities Company and their Customers

MPUC Docket No.: G-007,011/CI-02-1369

Kim R. Manney, being first duly sworn on oath, deposes and states that on the 1st day of November, 2002, copies of Aquila Reply Comments in the above referenced matter, were hand delivered or mailed by United States first class mail, postage prepaid thereon, to the following:

Dr. Burl W. Haar
Executive Secretary
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Kim R. Manney

SWORN TO BEFORE ME this
1st day of November, 2002.

NOTARY PUBLIC

CYNTHIA KAY ANDERSON
Notary Public
Minnesota
My Commission Expires Jan. 31, 2005

534940/1

STATE OF MINNESOTA
BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

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

In the Matter of an Inquiry into Possible Effects of the Financial Difficulties of Aquila, Inc. on Peoples Natural Gas Company and Northern Minnesota Utilities Company	MPUC Docket No.: G007,011/CI-02-1369

AQUILA REPLY COMMENTS

These Reply Comments are submitted by Aquila, Inc. in response to the Department of Commence ("DOC") October 22, 2002 Comments in the above-entitled docket. The DOC acknowledges that the "Company has taken aggressive steps to improve liquidity and remove debt from its balance sheet. Although these measures have, as of yet, failed to improve the Company's debt ratings, Aquila's long term strategy seems to offer the Company the best route to financial security and continued viability." No one is more concerned about the Company's financial health or working harder to improve it than its management. The Company has addressed its financial problems openly and vigorously.

In June, when Aquila realized that financial problems were occurring in the industry that were affecting its own financial condition, Aquila initiated contact with the Commission and requested the opportunity to discuss those matters. Scheduling problems prevented that from occurring until August 20. Commission Staff also contacted Aquila personnel on August 14, 2002 to give the Company notice that the Commission's August 29 agenda would include an initial inquiry into the possible effects of Aquila's financial difficulties on Peoples and NMU. During this contact, Staff requested copies of Aquila's most recent 10Q, 10K and FERC investigation filings. Aquila e-mailed copies of these documents the same day in order to help the Staff complete its review and briefing paper in time for the August 29 agenda meeting. Staff also advised Aquila of its general concerns and questions, which Mike Jonagan, then CEO of U.S. Utilities, attempted to address in his August 26, 2002 letter to the Commissioners. The sole purpose of providing this letter prior to the August 29 agenda meeting was to provide the assurances that Aquila understood the Commission wanted.

Based on its general understanding of the Commission's concerns, Aquila arranged on short notice for Mike Jonagan, then CEO U.S. Utilities; Jon Empson, Senior V.P.; Bennie Smith, Operating V.P. Minnesota; and Mike Cole, Assistant Treasurer, to participate in the August 29 Commission agenda meeting to ensure that all questions could be addressed.

With this Reply, Aquila continues to cooperate with the Commission and the DOC in a spirit of responsiveness and openness, providing a further update on Aquila's current financial condition, providing a further explanation of its foreign utility investment arrangements, and responding to the DOC's specific recommendations and concerns.

1. The Company's Current Financial Condition.

Since the August 29 hearing and the September 18 compliance filing, Aquila has made significant progress in closing several asset sales. As of October 29, the sale of $977 million of assets has been announced, of which $797 million have been closed. While the asset sales are raising cash to retire debt, the full impact of the transactions is also creating net book losses and lowering the earnings potential of Aquila. Aquila has also continued to restructure its businesses and, as discussed in the second quarter

10Q, anticipates a second phase of restructuring charges to be reflected in the third-quarter results. Given the speed with which the Company has been executing the business restructuring and the closing of asset sales, Aquila now expects that the credit rating agencies could review the current ratings when Aquila announces its third quarter earnings in early November. Attachment A to this filing is a copy of Aquila CEO, Rick Green's October 22 presentation at EEI's Financial Analyst Conference which presentation contained financial updates. Aquila provided copies of this presentation to Staff and DOC via e-mail the day the presentation was made to ensure that current information was available to the agencies.

2. The Company's International Utility Investment Arrangements.

The DOC's comments find fault with how the Company explained some of its foreign debt arrangements. As further explained below, the Company's international utility investments were openly presented to, and approved by, the Commission at the time they were made. Those acquisitions and financing arrangements were nothing out of the ordinary for these types of transactions and were related to utility operations, not unregulated operations as inferred. Aquila elected to acquire foreign utilities to reduce its risk by making investments in more than one economic market.

The DOC found Aquila's explanation of its foreign investment financing confusing. Hopefully the following explanation will eliminate this confusion. Basically, there were two tiers of financing involved: debt at the operating company level and debt to support Aquila, Inc.'s equity investments in the international operating companies. The debt at the operating company level is non-recourse to Aquila, is not guaranteed by Aquila, and does not cross-default to Aquila (see p.5 of Aquila's September 18

Compliance Filing). Contrary to DOC's concerns, none of this debt was, nor should it be, included in the potential capital calls discussed in either the 10Q or in the Company's response to Information Request No. 7.

In contrast, the debt incurred to make the "equity investment" in the international utilities is, in some instances, guaranteed by Aquila and those guarantees usually include cross-default language (again see p.5 of Aquila's September 18 Compliance Filing). The nature of the foreign investments, including any guarantees, was disclosed in Aquila's filings with the Minnesota Commission and reviewed by the Department of Public Service ("DPS") at the time of the investments. The Commission, with the DPS' concurrence, approved those foreign investments and, where applicable, loan guarantees in four separate dockets. See the Commission's June 15, 1993 Order Granting Limited and Conditioned Certification, in Docket No. G011/S-93-281 ("Docket 281"); November 30, 1994 Order Granting Certification Subject to Limitations and Conditions, in Docket No. G011/S-94,-907; June 9 1995 Order Finding Authority, Resources and Intent to Use Them and Requesting Filings and July 18, 1995 Order Granting Recertification, in Docket G011/S-95-204 (involved a guarantee); and the August 17, 1998 Order Granting Certification with Conditions, in Docket No G007, 011/S-98-682 (involved a guarantee). In each of these dockets, the manner of financing, including any loan guarantees was disclosed. In addition, based upon the disclosed information, the Commission was aware of the potential risk associated with these foreign investments. For example, in Docket 281, the Commission expressly noted that because Peoples and NMU receive all of their financing from UtiliCorp, any "increase in financial risk due to its purchase of an interest in [a foreign utility] . . . may

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result in an increased cost of capital." The Commission further noted, however, its ability to protect the ratepayers from these potential risks by establishing an appropriate cost of capital. This historical perspective is provided only to demonstrate that the nature of the investments were disclosed and discussed at the time the transactions took place.

It is the debt securing Aquila's equity interest in the foreign utilities which had some call potential and was disclosed by Aquila in the 10Q, in the September 18 Compliance Filing, and in the response to Information Request No. 7. It is this important distinction between debt at the operating company level versus the debt to fund the equity investment which appears to have created confusion.

If after reviewing these comments there is continued confusion or if the DOC has additional questions, the Company recommends a face-to-face meeting with DOC staff so that it can either further clarify or provide the DOC the information it is seeking. While written information requests provide a record of the information exchanged, they are difficult to write in a manner that assures receipt of all of the desired information and therefore can sometimes lead to confusion and frustration as appears occurred in this case.

3. Responses To Specific DOC Recommendations.

a. Comments On The Commission's Jurisdiction In The Event Of Bankruptcy.

The DOC recommends that Aquila provide a full and complete report analyzing Aquila's belief that Minn. Stat. § 216B.50 will continue to protect ratepayers' interests in the event of an Aquila bankruptcy. Aquila's understanding of the current landscape of the preemption of the U.S. Bankruptcy Code (the "Code") over state law would be in no way superior to that of the Commission's representative from the Minnesota Attorney General, nor would it carry any more precedential or binding value for the Commission. However, given the Commission's recognized interest in the effect a bankruptcy would have on the Commission's regulatory jurisdiction over a utility, Aquila offers its belief and understanding here, reserving all rights to make any legal arguments available under applicable law in the future.

As operating divisions of the corporate entity Aquila, Inc., Aquila's Peoples and NMU operations and assets would fall under the jurisdiction of a bankruptcy court if Aquila were to seek the protections allowed under the Code. Minn. Stat. § 216B.50 requires Commission approval of any sale of a public utility or of an operating system valued over $100,000, but the question remains: Would the Code, and judicial decisions thereunder, operate to preempt the Commission's authority under Section 216B.50. Unfortunately, Aquila has found no Eighth Circuit or U.S. Supreme Court decisions that address this issue. Even if Aquila exhaustively canvassed the cases of every jurisdiction in the United States, there is no guarantee that a specific bankruptcy court would decide the same way in a potential Aquila case.

Subject to the above caveats, Aquila is aware of no bankruptcy cases in which a court has approved and ordered the sale or transfer of utility assets outside the jurisdiction of the relevant state public utility commission. In fact, in one case, the court made its approval of a sale of assets outside the ordinary course of business during bankruptcy expressly subject to regulatory approval. In re WFDR, 7 BCD 514 (Bkr. Ct. N.D. Ga. 1981). Accordingly, it is Aquila's belief that any transfers or sales that a court might order in an Aquila bankruptcy case would remain consistent with the practice of respecting public utility commission jurisdiction over such sales and transfers. Additionally, it is Aquila's understanding that if Peoples or NMU assets were sold in an Aquila bankruptcy, the Commission's jurisdiction over those assets would remain intact following such a sale (including with respect to future transfers, ratemaking, and other regulations), and no bankruptcy or other body of law appears to hold to the contrary.

However, pursuant to clear language contained in Section 1123(a) of the Code, a confirmed reorganization plan under Chapter 11 of the Code may provide for the transfer of assets "[n]ot withstanding any otherwise applicable nonbankruptcy law."

As discussed in the recent PG&E bankruptcy and related appellate proceedings in California, courts of various jurisdictions have debated whether the Section 1123(a) language provides for "express preemption" (obviating application of state law generally) or "implied preemption" (allowing preemption only in cases where (a) the applicable state statute is concerned with economic regulation rather than with protecting public health and safety and (b) no feasible plan would be confirmable in the absence of preemption). In the context of a preliminary matter in the PG&E case, the U.S. Bankruptcy Court for the Northern District of California analyzed the applicability of preemption with respect to a pre-confirmation disclosure statement and declared that a transfer of assets pursuant to a confirmed plan would not be subject to state regulatory approval. See In re Pacific Gas & Elec. Co., 2002 U.S. Dist. LEXIS 16499 (Aug. 30, 2002). Again, this decision relates to a preliminary disclosure statement, so it is not clear what the confirmed plan will ultimately look like or whether preemption will ever come to fruition.

With respect to the impact that Aquila's corporate structure may have to diminish or otherwise limit the protection that Minnesota ratepayers may have in the event of an Aquila bankruptcy, Aquila notes that under a Chapter 11 reorganization plan, the stock of the subsidiaries of a holding company could also be sold. Accordingly, while the corporate structure of the utility may be a consideration in the development of a confirmable reorganization plan, it would provide no guarantee of the Commission's continued jurisdiction over the transfer or sale of the utility.

b. Ratepayer Protections From Higher Capital Costs

In his letter to the Commission dated August 26, 2002, Mike Jonagan stated:

> Aquila acknowledges that (a) Minnesota ratepayers should pay no more for debt costs than would be incurred by an investment grade utility, and (b) the Commission has the authority during the ratemaking process to use a hypothetical debt structure to address debt costs higher than those of an investment grade company, if such a case arises.

Thus, the Company agrees with the DOC that Minnesota customers should only be responsible for a cost of equity or debt consistent with the cost of capital for comparable gas distribution companies. The Company also agrees with the DOC's specific recommendations regarding the cost of capital.

It should be noted that during the pending rate case both the DOC and Aquila agreed on using a group of comparable gas distribution companies to determine the cost of equity. As stated by DOC witness Amit, "... a DCF analysis for UtiliCorp would not result in a reasonable estimate of the cost of equity for PNG and NMU. Instead, I have performed a DCF analysis on a group of companies with investment risks similar to those of PNG and NMU." (p.5, line 14-17 Direct.) DOC witness Amit continued by stating: "The obvious candidates are other gas distribution companies." (p.5, line 22-

23.) Company witness Dunn also used a comparable company approach to determine the cost of equity. The company position is the same today. Therefore, assuming that the DOC maintains its position, the solution to the cost of equity concerns raised by DOC has already been agreed to by both parties. That is, cost of equity should be determined using a group of comparable gas distribution companies rather than based directly on Aquila's cost of equity.

- <u>DOC Recommendation</u>: In Aquila's next rate case, the Company identify all issuance of debt and associated cost from January 1, 2002, until its next rate case in a manner that will facilitate a potential adjustment to mitigate impacts of adverse market factors caused by Aquila's financial problems. Specifically, the Company must provide information sufficient to allow the Commission to evaluate what Peoples' and NMU's debt and equity costs would be but for the effects of its other operations.

  <u>Response</u>: Agreed. As stated by Mike Jonagan in his August 26 letter to the Commission, Aquila has already made this commitment on debt, and has adopted a methodology for equity that addresses the DOC's concerns, and therefore agrees with DOC's recommendation.

- <u>DOC Recommendation</u>: The Company provide a discussion and analysis in its next rate case of the effects at that time of Aquila's financial situation on Peoples' and NMU's costs of common equity.

  <u>Response</u>: Agreed. Again, unless the DOC and/or Commission were to set rates using Aquila, Inc.'s actual cost of equity, rather than a proxy based on comparable gas distribution companies such as Aquila, DOC,

and the Commission have used in other Company rate cases, this should not be an issue.

- <u>DOC Recommendation</u>: Aquila should report immediately any significant financial event for Aquila and provide copies of any report made to the SEC or any other federal agency from now on.

  <u>Response</u>: Agreed. The Company's web site provides the opportunity for all interested persons to obtain automatic notice of all significant financial events including copies of all SEC filings. Anyone wishing to receive such automatic notices can go to the Company's website: <u>www.aquila.com</u>. On the home page, click on the heading "Investors", and then click on "Investor Contacts & Information". Then sign up for

  E-mail Alerts, which provides automatic notice of news releases, company events, new financial documents, including notice of SEC filings. The Company's SEC filings are also accessible using the Company's web site, by clicking on the word "Investors" and then clicking on "SEC Filings" and then clicking on the direct link to a third-party service that provides copies of the filings by name and also in a searchable format.

- <u>DOC Recommendation</u>: In its Reply Comments the Company should explain why it did not file for Commission approval of its most recent debt issuances.

  <u>Response</u>: Foreign corporations like Aquila, which is a Delaware corporation, are only required to obtain Commission approval of a security issuance if it encumbers Minnesota utility property for the purpose of

securing the debt. As the DOC acknowledges in footnote 10, Commission approval of the credit facilities was not required because "Minnesota property was not specifically used to secure any credit facilities . . . ."

More specifically, Minn. Stat. § 216B.49, subd. 3, provides:

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

(Emphasis added.) None of the debt issuances referenced by the DOC encumbered any Minnesota property for the purpose of securing the payment of the indebtedness.[1]

The above discussion of the Commission approval requirements under Section 216B.49, subd. 3, is further based on the Commission's interpretation of this section in Docket 281. In that Docket, the Commission stated:

> The Commission also has other regulatory authority which would apply if certain aspects of the acquisition were changed. For instance, if the acquisition were modified to result in the encumbrance of any Minnesota property,

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[1] As the DOC notes, the Company's revenues and property are always available to creditors in the case of a bankruptcy, but that is not an encumbrance. Minn. Stat. § 336.2A-309 of the Uniform Commercial Code defines an encumbrance to include "real estate mortgages and other liens on real estate and all other rights in real estate that are not ownership interests." An encumbrance limits the ability of the owner of the property to sell the property and allows the debt holder to force the sale of the asset in the event of a default. None of the Company's debt issuances placed a lien on Minnesota utility property. The DOC notes that the Company is subject to the federal bankruptcy laws. The potential application of the bankruptcy laws is not a lien on the Company's Minnesota property. Further, because of the universal application of bankruptcy, if it were treated as a lien, it would render the exemption from Section 216B.49 meaningless. Minn. Stat. § 645.17 provides the following prescription in interpreting legislation: "the legislature intends the entire statute to be effective and certain."

Commission approval of UtiliCorp's resulting capital structure would be required under Minn. Stat. § 216B.49, subd. 3 (1992).

c. Quality of Service Standards.

The DOC requests that the Company propose a gas service quality standards plan, including information on how service quality response times will be recorded. The Company previously agreed to voluntarily provide internal management reports which will reflect the Company's standards for accidents, leaks, emergency response time, meter reading, billing accuracy, and overall customer satisfaction. The Company further explained its intentions with respect to these reports in response to a DOC data request.

The purpose of these reports is to assist the Company in managing its operations. Over time, it is expected that the areas studied will change in response to newly identified issues. The Company recommends that the Company and DOC meet and review the internal management reports and see if the content addresses the DOC's concerns. The Company requests that the Commission not seek to regulate this management tool. Nor should the Commission order specific service quality standards absent either a rulemaking proceeding or a specific service quality problem and evidence on the reasonableness of the standard as applied to Aquila. For example, the standards developed for NSP for emergency response times reflects that Company's largely urban setting and should not apply to Peoples and NMU, which serve a very large and significantly more rural area.

CONCLUSION

Aquila has attempted in this proceeding to provide the Commission, its Staff and the DOC with detailed information about Aquila's current financial condition. Aquila initiated the discussions, made senior management available for questions, made all

SEC and FERC filings available, and responded to all information requests in a comprehensive manner. Aquila hopes that this Reply clarifies any confusing aspects of the Compliance Filing. Aquila remains very willing to continue to provide complete and candid responses to all of the Commission's and DOC's questions.

Dated: November 1, 2002

Respectfully submitted,

By ______________________
Michael J. Bradley

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Attorneys on Behalf of Aquila, Inc.

ATTACHMENT A

Aquila

Transitioning from an Energy Merchant to an Integrated Utility

EEI / October 2002

Forward Looking Statements

- The statements made with respect to Aquila's earnings and outlook for the future contain some forward-looking information. Naturally, all forward-looking statements involve risk and uncertainty and actual results or events could be materially different. Although Aquila believes that its expectations are based on reasonable assumptions, it can give no assurance that its goals will be achieved.
- Important factors that could cause actual results to differ include: unusual weather conditions; economic and financial market conditions, including changes in exchange rates, interest rates, and commodity prices; changes in our credit rating; competition in the markets in which our businesses operate; and changes in applicable laws, regulations, or rules governing energy, environmental, tax, or accounting matters. In light of these risks, uncertainties, and assumptions, the forward-looking events discussed might not occur. Please review the company's latest annual report on Form 10-K, quarterly report on Form 10-Q, any current reports on Form 8-K, and recent press releases for other important factors that could cause results to differ materially from those in any such forward-looking statements.
- Information in these archived materials may not be current and may be superseded by more recent information published by Aquila.

Discussion Topics

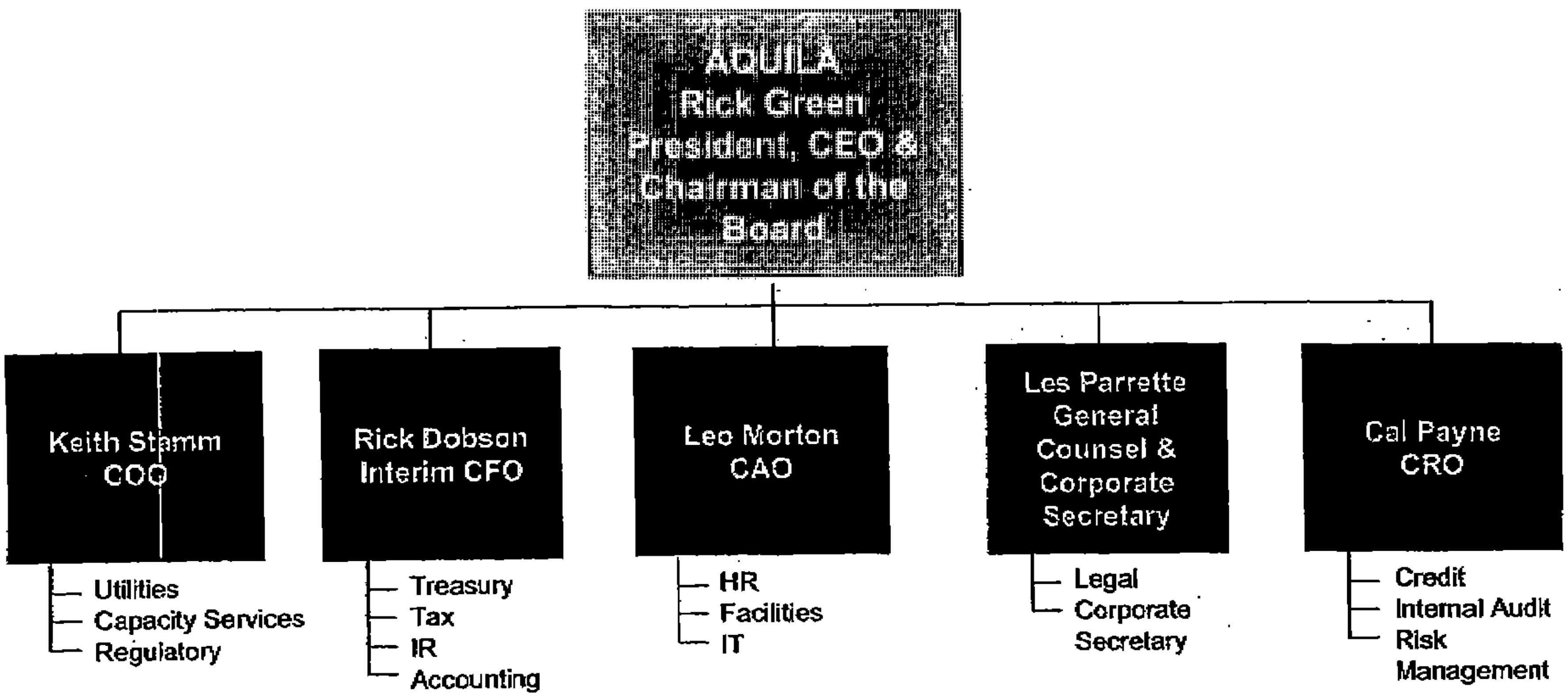
- Industry Issues
- Leadership Team
- Transition
- Asset Sales
- Liquidity
- ILA Challenges
- Current Priorities

Aquila

Industry Issues

- Underestimated Impact of Enron Demise
- Credit and Liquidity Concerns
  - No one is bullet proof
  - Cost of liquidity is Infinite
- Fundamentals Impacting Generation
  - Supply & demand
  - Boom & bust cycle
  - Lack of liquidity
- Outlook for 2003
  - Continued over supply of generation
  - Backlog of asset sales
  - Uncertain capital markets

Leadership Team



Aquila

Aquila Overview (pro forma)

LAST YEAR

AQUILA

- U.S. UTILITIES
- INT'L UTILITIES
- TRADING
- CAPACITY

NEXT YEAR

AQUILA

- U.S. UTILITIES
- CANADA AUSTRALIA UTILITY
- NON-REGULATED GENERATION

TRANSITION

Selling:

- NZ
- UK
- Midstream
- Loan Portfolio
- Quanta

Asset Sales

DESCRIPTION	ESTIMATED CLOSING DATE	CASH PROCEEDS	ESTIMATED GAIN/(LOSS) AFTER TAX	2002 EBIT LOST	
SIGNED:					
▸ GAS GATHERING AND PROCESSING	CLOSED	$265.0 M	$(156 M)	$20 M	Closed with ET Company
▸ LOCKPORT IPP	CLOSED	$37.5 M	$(5) M	$6 M	Closed with Forlstar Capital
▸ NEW ZEALAND	CLOSED	$362.0 M	$28 M	$31 M	Closed with Vector
▸ HOLE HOUSE STORAGE	CLOSED	$34.9 M	$(9) M	$0 M	Closed
▸ QUANTA 16.4M SHARES	CLOSED	$44.0 M	$(5) M	$12 M	Closed
▸ MALLON CREDIT	CLOSED	$30.5 M	Not Available	Not Available	Closed with BlackHills
▸ OTHER ASSETS	CLOSED	$22.7 M	Not Available	Not Available	Closed
▸ KATY STORAGE	11/1/2002	$180.0 M	$20 M	$6 M	Pending close with PacifiCorp Power
		$976.6 M	$(127) M	$75 M	
IN PROGRESS:					
▸ LOAN PORTFOLIO		NOT AVAILABLE			
▸ QUANTA 12.8M SHARES		NOT AVAILABLE			
▸ MIDLANDS		NOT AVAILABLE			

- Will achieve $1 Billion plus in asset sales
- Proceeds will reduce debt
- Asset sales will require bank consents

Aquila

Liquidity - Estimated

SOURCES:	
CASH ON HAND 9/30/02	$515
REVOLVER CAPACITY ($151 in LOC's)	99
LIQUID ASSETS	40
ASSET SALES - ANNOUNCED, NOT CLOSED 9/30/02	897
	1,551
OPERATING CASH FLOW	0
CAPITAL EXPENDITURES:	
NETWORKS	(74)
CAPACITY	(15)
EVEREST	(31)
NET OPERATING CASH FLOW	(120)
SCHEDULED PAYMENTS:	
DIVIDENDS	(34)
MIDLANDS BRIDGE	(194)
NEW ZEALAND	(127)
AUSTRALIA	(81)
	(436)
ESTIMATED NET LIQUIDITY 12/31/02	$995

Collateral Calls Since Moody's Downgrade

DESCRIPTION	TOTAL ESTIMATED PER 2Q 10Q	MOODY'S ESTIMATED PER 2Q 10Q	AMOUNT POSTED
DEBT	$177 M	$85 M	* $81 M
FINANCIAL	62 M	62 M	40 M
TOLLS & CONSTRUCTION LOAN	110 M	45 M	73 M
OTHER POTENTIAL DEMANDS	135 M	135 M	41 M
	$484 M	$327 M	$235 M

* $81M of debt was paid upon its maturity in October

- Better than expected results
- Downgrade reduced # of willing suppliers
- Reduced credit terms

Aquila

ILA Challenges

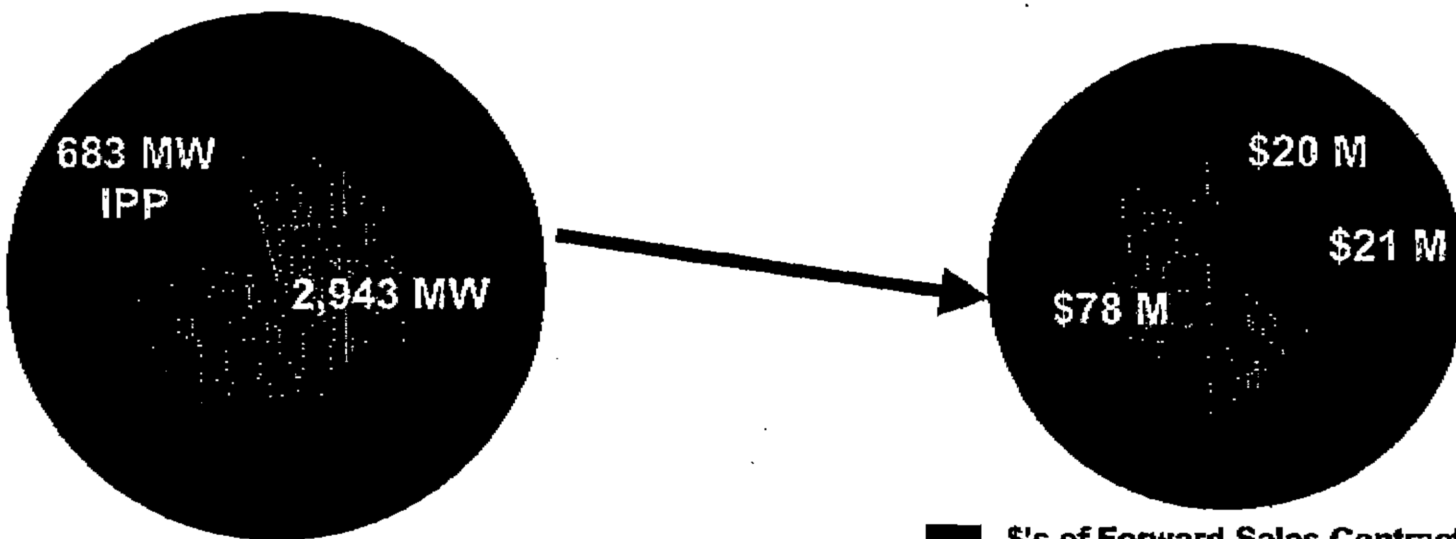
Challenges	Related Factors
ASSET SALES	▸ Economic result, net loss ▸ Accruing losses now ▸ Execution risk (buyers' market) ▸ Resizing corporation
NON-REGULATED GENERATION	▸ High reserve margins ▸ Low spark spreads ▸ Lack of liquidity ▸ Fixed costs
CAPITAL/BANK MARKETS	▸ Cost of & access to capital ▸ Need for self-reliance

Challenges result in moving targets on earnings and lack of visibility/clarity

Aquila

Our Generation Portfolio - 2003

Total MWs | **Cash Economics**



- IPP MW'S
- Merchant MW'S

- $'s of Forward Sales Contracted
- $'s of Financial Hedges
- $'s of Unrecovered Capacity Costs

Answer Key:
- Forward Sales Contracted = P/L & cash flow both hedged
- Financial Hedge = Cash flow hedged; P/L MTM

Aquila

Current Priorities - Stability

BUSINESS STABILITY

Domestic & International Utilities and Capacity Services

- Serve customers
- Optimize assets
- Improve relationships

FINANCIAL STABILITY

Improve Cash Flow

- Execute asset sales
- Control costs
- Manage banks
- Minimize collateral calls

CREDIBILITY

Commit & Deliver

- Communicate frequently
- Act as "one" company
- Inspire confidence

STATE OF MINNESOTA
BEFORE THE PUBLIC UTILITIES COMMISSION

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

In the Matter of an Inquiry Into Possible Effects of the Financial Difficulties at Aquila, Inc. on Peoples Natural Gas Company and Northern Minnesota Utilities Company and their Customers

Docket Number: G007,011/CI-02-1369

REPLY COMMENTS OF THE OFFICE OF THE ATTORNEY GENERAL

INTRODUCTION

The Residential and Small Business Utilities Division of the Office of the Attorney General ("OAG") respectfully submits these Reply Comments in response to the Comments of the Minnesota Department of Commerce ("Department" or "DOC")[1] and the Compliance Filing[2] and responses to Information Requests of Aquila, Inc. ("Aquila") with respect to its Peoples Natural Gas Company-Minnesota ("Peoples" or "PNG") and Northern Minnesota Utilities ("NMU") divisions. These Reply Comments are restricted to the issue of Minnesota Public Utility Commission ("Commission") jurisdiction in the event of an Aquila bankruptcy.

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[1] *See* Department's *Comments On Inquiry Into Possible Effects Of Financial Difficulties at Aquila, Inc. On Peoples Natural Gas and NMU and Its Customers,* MPUC Docket No. G007,011/CI-021369 (October 22, 2002).

[2] *See Compliance Filing In the Matter of an Inquiry Into Possible Effects Of Financial Difficulties at Aquila, Inc. On Peoples Natural Gas and NMU and Its Customers,* MPUC Docket No. G007,011/CI-021369 (September 18, 2002).

I. THE COMMISSION MAY LOSE JURISDICTION OVER REGULATION OF AQUILA ASSETS IN THE EVENT OF BANKRUPTCY.

In DOC Information Request Number 6 (October 4, 2002), the Department asked, "How are the Peoples' Natural Gas-Minnesota and Northern-Minnesota Utilities' assets insulated from a potential bankruptcy of Aquila, Inc.?" Aquila replied as follows:

> Aquila's Minnesota PNG and NMU operations are conducted as a division of the corporate entity Aquila, Inc. Accordingly, if Aquila, Inc. were to file for protection under the bankruptcy laws, the assets held by that corporate entity (i.e., including its divisions) would fall under the jurisdiction of the bankruptcy court. However, it is Aquila's belief that Minnesota Statute § 215B.50 will continue to prohibit dispositions (in excess of $100,000) of PNG's and NMU's assets without first obtaining Commission approval. This statutory protection will operate to preserve the Commission's jurisdiction over the utilities' assets for the benefit of the rate-paying customers.

The OAG is not so optimistic with respect to Commission jurisdiction in the context of an Aquila bankruptcy. The Bankruptcy Code (11 U.S.C. § 101 et seq) and recent case law operate against the application of state statutes such as § 215B.50.[3] [4]

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[3] It is important to note that 11 USC § 1129(a), which specifies the conditions precedent for approval of the plan by the bankruptcy court, provides that state public utility commissions retain regulatory authority over ratemaking, even in bankruptcy:

> (a) The court shall confirm a plan only if all of the following requirements are met:
>
> *   *   *
>
> (6) Any governmental regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such approval.

[4] To illustrate the enormous sweep of the power of the Bankruptcy Code, *see In re Good Time Charlie's Ltd.*, 25 B.R. 226 Bankr. (E.D.Pa., 1982), holding that a shopping mall, which supplied electricity to a bankrupt restaurant in the mall, was a "utility" within the meaning of the Bankruptcy Code and therefore could be enjoined from discontinuing the debtor-restaurant's
(Footnote Continued on Next Page)

II. The Recent PG&E Bankruptcy Order Rules That Almost All State Regulatory Authority Is Preempted By The Bankruptcy Court.

On April 6, 2001, PG&E filed a voluntary petition under Chapter 11 of Title 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Northern District of California. On February 7, 2002, the bankruptcy court issued its Memorandum Decision and on March 18, 2002 its Order regarding preemption and sovereign immunity, rejecting PG & E's "across-the-board, take-no-prisoners" claim that § 1123(a)(5) allows it to "disaggregate with unfettered preemption of any contrary nonbankruptcy law." Bankr. Dec. (ER 863) at 46, 40. PG&E appealed the bankruptcy court's decision to the United States District Court for the Northern District of California. The latter court's recent bankruptcy ruling from August 30, 2002, in a major victory for Pacific Gas & Electric Co. ("PG&E"), established that federal bankruptcy law overrides any state law that interferes with the utility debtor's proposed reorganization, thus ending most state regulation of the company.[5] PG&E wishes to transfer its power plants and transmission systems to newly created companies that would fall under the authority of the Federal Energy Regulatory Commission ("FERC"). The properties would then be used as collateral to repay PG&E's $13 billion in debts. The issue of whether a bankruptcy plan pre-empts state law is a crucial issue in this case, as PG&E's plan conflicts with numerous California laws. One such law that took effect last year prohibits California utilities from selling or transferring power plants until 2006. An earlier state law requires CPUC approval for sales of utility assets, similar to Minn. Stat. § 216B.50. The CPUC contends PG&E would also need

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electrical service notwithstanding fact that it had terminated debtor's electrical service prior to the debtor's filing for bankruptcy under Chapter 11.

[5] *See In Re: Pacific Gas and Electric Co.*, 283 B.R. 41 (N.D.Cal., August 30, 2002).

environmental review under state law before transferring the land around its hydroelectric plants.[6]

In overruling the Bankruptcy Court's ruling that PG&E could not automatically preempt state laws that got in the way of its plan, the Federal District Court noted that provisions of the 1984 federal bankruptcy law showed that Congress intended to pre-empt any law impeding transactions necessary to implement the reorganization plan. The Court also noted that state commissions, which formerly held veto power over utility bankruptcy plans, were limited by Congress in 1978 to ruling on rate increases caused by the plans. The Court found it was Congress' intent that public utilities no longer be subject to the costs, delays and uncertainty of state approval of their reorganizations.[7] The Court further reasoned that its holding is consistent with the few other rulings that exist on the scope of 11 U.S.C.§ 1123(s)(5):

> As noted, every court except the bankruptcy court below to have considered § 1123(a)(5) has concluded that this section contains an express preemption of nonbankruptcy laws that would otherwise apply to the restructuring transactions provided for in a reorganization plan. The case law on this subject is, however, rather limited. By far, the court to have considered this matter in the most depth is the United States Bankruptcy Court for the District of New Hampshire in *Public Service Company of New Hampshire v New Hampshire (In re Public Serv. Co)*, 108 B.R. 854 (D.N.H.1989). After conducting a quite helpful and thorough analysis of the (again rather limited) legislative history of § 1123(a), the New Hampshire bankruptcy court concluded that the meaning of § 1123(a)(5) is clear:
>
>> With regard to the present statutory provision before the court, i e § 1123(a)(5) providing that "notwithstanding any otherwise applicable nonbankruptcy law" a plan of reorganization "shall" contain adequate provisions for the plan's implementation, in terms

[6] It should be noted that not only is the issue of state public utility regulation at stake, but the United States Environmental Protection Agency weighed in the PG&E case because an approved bankruptcy plan could override even other *federal* statutes, such an environmental laws that would otherwise bar transactions necessary to implement the reorganization plan.

[7] The CPUC is in the process of appealing Walker's Order, and the OAG has learned that Oregon may take the lead in organizing efforts to coordinate other states in filing an amicus brief.

of the necessary restructuring of the debtor and its assets and liabilities common to all plans of reorganization in complex cases, the statute would seem to be plain on its face to indicate an express preemptive intent as to such restructuring provisions of a Chapter 11 plan of reorganization. Id. at 882.

Pacific Gas and Electric 283 B.R. at 48. Although *In re PG&E* is only a district court reversal of a bankruptcy order in another federal Circuit, so that even if it stands up on appeal to the Ninth Circuit it will have no controlling effect on rulings pertinent to Minnesota public utilities (unless it is ultimately upheld by the United States Supreme Court), because of the paucity of case law regarding public utility bankruptcies, there is no doubt it will be looked to by courts in all venues dealing with this issue. In the words of the overruled bankruptcy court:

> This is a Chapter 11 case of enormous significance to thousands of creditors owed billions of dollars. It is clearly one of the largest bankruptcies in United States history, and definitely the largest involving a public utility. An attempt by a utility to free itself from state regulation to the extent contemplated by the Plan is virtually without precedent. Bankr. Order (ER 924) at 5-6.

The CPUC has filed a Motion for Stay Pending Appeal of the State of California and Others to the United States Court of Appeals for the Ninth Circuit.[8] Without a stay, appeal to the Ninth Circuit could be dismissed as moot if PG&E swiftly implements its proposed plan. The CPUC argues that 11 USC § 1123(a) does not expressly preempt all state and federal law applicable to a Chapter 11 restructuring, and that the Bankruptcy Code contains a presumption against preemption overall.

[8] Motion for Stay Pending Appeal of the State and Others, *In Re: Pacific Gas and Electric Company*, Case No. C 02-01550 VRW, U.S. District Court (October 8, 2002, N.D.Cal.).

CONCLUSIONS

The OAG submits that if Aquila, Inc. were to file for protection under the bankruptcy laws, contrary to Aquila's assertions, the Commission's authority under Minn. Stat. § 215B.50 governing the transfer of public utility assets may be preempted by the bankruptcy court. In addition, except for its express authority in the Bankruptcy Code to approve changes in rates, the Commission and, indeed, all other state and federal regulatory agencies could be rendered virtually powerless with respect to the regulation of a bankrupt public utility.

Dated: November 1, 2002

Respectfully submitted,

MIKE HATCH
Attorney General
State of Minnesota

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AG: #752811-v1

AFFIDAVIT OF SERVICE BY U.S. MAIL

Re: ***In the Matter of Peoples Natural Gas and NMU Inquiry into Possible Effects of Financial Difficulties at Aquila***
MPCU Docket No. G007,011/CI-02-1369

STATE OF MINNESOTA)
) ss.
COUNTY OF RAMSEY)

KAREN J. NEAL, being first duly sworn, deposes and says:

That at the City of St. Paul, County of Ramsey and State of Minnesota, on November 1, 2002, s/he caused to be served the REPLY COMMENTS OF THE OFFICE OF THE ATTORNEY GENERAL, by depositing the same in the United States mail at said city and state, true and correct copy(ies) thereof, properly enveloped with prepaid first class postage, and addressed to:

See Attached Service List

Karen J. Neal
KAREN J. NEAL

Subscribed and sworn to before me on
November 1, 2002

Sharon Hackenmueller
NOTARY PUBLIC

SHARON HACKENMUELLER
NOTARY PUBLIC - MINNESOTA
MY COMMISSION EXPIRES
JANUARY 31, 2005

SERVICE LIST

Re: In the Matter of Peoples Natural Gas and NMU Inquiry into Possible Effects of Financial Difficulties at Aquila
MPUC Docket No. G007,011/CI-02-1369

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November 1, 2002

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Re: ***In the Matter of Peoples Natural Gas and NMU Inquiry into Possible Effects of Financial Difficulties at Aquila***
MPCU Docket No. G007,011/CI-02-1369

Dear Dr. Haar:

Enclosed for filing, please find the original and 14 copies of the Reply Comments of the Office of the Attorney General in regard to the above-referenced matter, along with the Affidavit of Service.

If you have any questions, please feel free to contact me at the number listed below.

Sincerely,

Ronald Giteck

RONALD M. GITECK
Assistant Attorney General

(651) 284-4066

Enc.

cc: See Attached Service List

AG: #752371-v1

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