**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
SURREBUTTAL TESTIMONY OF SUSAN D. ABBOTT
ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS AND AQUILA NETWORKS-L&P
CASE NOS. ER-2004-0034 AND HR-2004-0024 (CONSOLIDATED)**

Q. PLEASE STATE YOUR NAME.

A. My name is Susan D. Abbott.

Q. ARE YOU THE SAME SUSAN ABBOTT WHO FILED REBUTTAL TESTIMONY IN THIS PROCEEDING FOR AQUILA, INC. ("AQUILA")?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of my surrebuttal testimony is to respond to and refute the appropriateness of determining creditworthiness using one financial metric as Missouri Public Service Commission staff witness David Murray implies as appropriate with his footnote in Revised Schedule 21 at the end of his rebuttal testimony dated January, 2004. In addition, Mr. Murray implies in his footnote on Revised Schedule 21 that the metric cited indicates investment grade status to those companies that achieve those numbers. The standards quoted are not those used by S&P either in 2000, as indicated in the footnote, nor today, as the same guidelines have been in place since 1999. Mr. Murray implies through his footnote that the metrics resulting from adoption of the staff recommendation places Aquila's MPS and L & P operating divisions within investment grade range.

Q. WHAT FINANCIAL METRIC HAS MR. MURRAY CHOSEN TO MEASURE CREDITWORTHINESS?

A. Mr. Murray has chosen to base his opinion of the creditworthiness of Aquila's MPS and L&P operating divisions on pre-tax interest coverage. The level of comfort that Mr. Murray appears to have in the financial condition of MPS and L&P resulting from the Staff recommendation appears to be based on a belief that pre-tax interest coverage levels are not only adequate for investment grade, but also signify, in the absence of any other measurement, a level of creditworthiness that just doesn't exist.

Q. IS PRE-TAX INTEREST COVERAGE AN IMPORTANT FINANCIAL METRIC?

A. Yes, it is. However, it is only one of many metrics used by the fixed income financial community, and is not considered the most important one. Not only is it not the most important, but no one accepts that one metric alone can provide enough information to determine creditworthiness.

Q. WHAT OTHER METRICS DO FIXED INCOME ANALYSTS AND RATING AGENCIES USE?

A. Standard & Poors (S&P) publishes four different financial metrics. They are 1) debt as a percentage of total capitalization, 2) cash flow as a percentage of total debt outstanding, 3) cash flow coverage of interest expense, and 4) pre-tax interest coverage.[1] However, S&P, Moody's, and other fixed income

[1] Typical calculations of these metrics are formulated as follows:
<u>Debt to Total Capitalization</u> = [(short term debt + current maturities + long term debt)/total capitalization)]x100

analysts use a number of other measurements when determining ratings. They look at, among other things, return on equity, net cash flow to capital expenditures, capital expenditures to average total capital, funds from operations to current obligations, earnings before interest and taxes to total assets, and further analysis of the cash flow coverage of all obligations including preferred stock. In addition to the financial targets listed above, rating agencies and fixed income analysts consider business risk, and comparative analysis of peer groups in order to add depth to their analysis of the quantitative measurements.

Q DO MPS AND L&P QUALIFY FOR INVESTMENT GRADE RATINGS BASED ON THE PRE-TAX INTEREST COVERAGE METRIC?

A. While I will reiterate that no one metric can indicate any particular rating, the pre-tax interest coverage ratio that would result from adoption of the Staff recommendation would not qualify either MPS or L&P for investment grade according to S&P's published guidance. The current metrics published by S&P, which I provided in Schedule SDA-1 to my rebuttal testimony, were adopted in June of 1999 and require between 2.4x on the lower end and 3.5x on the upper end for a utility with a business position of "5".

Q. WHAT DOES MR. MURRAY RELY ON?

Cash flow to total debt outstanding =[(net income + depreciation, depletion, amortization + deferred taxes + other non-cash items – total dividends paid)/(short term debt + current maturities + long term debt)]x100
Cash flow coverage of interest expense = [(net income + depreciation, depletion, amortization + deferred
Pre-tax interest coverage = (income before extraordinary items-equity income- debt and equity components of afudc + gross interest expense + total income tax)/ gross interest expense

A. Mr. Murray cites something he calls "S&P's Utility Rating Services as of July 7, 2000" in his Revised Schedule 21 as indicating financial medians for pre-tax interest coverage. These indicate that a "lower quartile BBB" could have coverage of 1.97x, a "median BBB", 2.53x and an "upper quartile BBB", 3.15x.

Q. HOW DO YOU RESPOND?

A. These are not the standards S&P uses now, nor did they in 2000, to determine its ratings. While neither S&P, nor I through independent research, can identify the source Mr. Murray is using, I can surmise that the numbers quoted by Mr. Murray represent actual performance of companies rated in those ranges at the time. If he chooses to use actual performance to justify his belief that pre-tax interest coverage at the level of 1.97x is a valid indicator of investment grade quality, he needs to update his numbers. In fact, if actual pre-tax interest coverage for 2002 is used as an indicator, you will find the average pre-tax interest coverage among the 65 investor-owned utilities charted by Edison Electric Institute to be 3.12x, without discarding anomalies as you normally would. The average rating of this same population in 2002 was BBB+[2] This level of pre-tax interest coverage is close to the upper end of the range used by S&P and to the "upper quartile" cited by Mr. Murray in his Revised Schedule 21.[3] However, S&P's lower end of the BBB range at 2.4x is far from the 1.92x cited by Mr. Murray on his aforementioned

[2] 2002 Financial Review, Annual Report of the Shareholder-Owned Electric Utility Industry, Edison Electric Institute
[3] 2002 Financial Review, Annual Report of the Shareholder-Owned Electric Utility Industry, Edison Electric Institute

Revised Schedule 21, indicating that his view of what is appropriate for investment grade is mistaken.

Q. IS ANY ONE METRIC MORE IMPORTANT THAN THE OTHERS?

A. No one metric by itself is more important than the others. Taken in concert, they help indicate the level of creditworthiness a company possesses. However, cash flow measurements such as cash flow coverage of interest expense, or cash flow to total debt outstanding, tend to be more instructive than accounting measures such as pre-tax interest coverage or debt to total capitalization.

Q. WHY IS THAT?

A. Cash flow measurements indicate more accurately how much cash is available to pay cash obligations like principal and interest on debt. Accounting measurements that don't take cash flow into account, like pre-tax interest coverage, which is based on calculations from the income statement and debt to total capitalization from the balance sheet, can result in an over-or-understatement of the situation.

Q. WHAT ACCOUNTS FOR THE DIFFERENCE?

A. Income or balance sheet calculations don't necessarily account for changes in working capital or the quality of earnings. For instance, in a June, 2000 publication entitled <u>Putting EBITDA in Perspective; Ten Critical Failings of EBITDA As the Principal Determinant of Cash Flow,</u> Moody's expresses the difficulty of using this income statement calculation as a measure of cash flow. Moody's states that "EBITDA ignores distinctions in the quality of cash flow resulting from differing accounting policies – NOT all revenues are cash." They further state "EBITDA can easily be manipulated through aggressive accounting policies relating to revenue and expense recognition…"

Q. WHAT ARE ANALYSTS CONCERNED ABOUT WHEN THEY USE INCOME STATEMENT CALCULATIONS?

A. A prime example of issues analysts look for when determining creditworthiness is the quality of earnings. By that, they mean how much of what falls to the bottom line is cash. If there is a lot of Allowance for Funds Used During Construction ("AFUDC") in earnings, analysts will be less comfortable than if there is none. That is simply because AFUDC, while an appropriate and helpful regulatory item, is not current cash. Therefore, it is not available to pay cash obligations. This is one demonstrable reason that a good credit analyst will use as many indicators that are at his or her disposal to determine creditworthiness rather than rely on one. None are perfect, and it is only while analyzing all of them together, that one can get a real sense of the likelihood that a company will be able to perform on its financial obligations in a timely manner.

Q. IS THERE A STRICT METHODOLOGY TO FIXED INCOME ANALYSIS?

A. Credit analysis is rather more an art than a science. Various organizations, like S&P, use rating guidelines that define what they believe a company needs to achieve in order to attain any particular rating. Others do not. Moody's, for instance, does not publish such guidelines. However, Moody's analysts compare companies against one another within a framework developed over years of experience to determine the appropriate rating. My 20 years of experience at Moody's tells me that the pre-tax interest coverage floor of 1.97x cited by Mr. Murray in his aforementioned footnote, is not adequate for investment grade. The 2.07x and 2.06x that MPS and L&P respectively would achieve under the Staff's recommendations are also not adequate for investment grade. S&P's minimum for companies like these with a "5" business risk, is 2.4x for investment grade.

Q. HOW WOULD YOU SUMMARIZE YOUR SURREBUTTAL?

A. I am concerned that a decision as important as this is being based on a narrow point of view regarding measures of creditworthiness. In addition, much of the testimony offered by the Staff concerns whether methodologies used are academically appropriate. And while one would like the methods chosen to be thoughtful and rigorous, in the end, the effects the decision has on the creditworthiness of MPS and L&P must be seriously considered. Claiming that pre-tax interest coverage, only one of many metrics used by serious analysts, at a level of 2.06x and 2.07x for MPS and L&P respectively, describe investment grade financial conditions when S&P's guidelines clearly state that 2.4x to 3.6x is required for a BBB, ignores the importance of creditworthiness to these two capital intensive utilities. This limited analysis also ignores the fact that the two cash flow measurements published by S&P, FFO to interest, and FFO to total debt, would be woefully below investment grade as a result of the Staff's recommendations.

Q. Does this complete your surrebuttal testimony?

A. Yes it does.