Exhibit No.:	
Issues:	*Overview; Recommendations and Conclusions; Working Capital*
Witness:	*Joan C. Wandel*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Revised Rebuttal Testimony*
Case No.:	*EF-2003-0465*
Date Testimony Prepared:	*September 18, 2003*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REVISED REBUTTAL TESTIMONY

OF

JOAN C. WANDEL

AQUILA, INC.

CASE NO. EF-2003-0465

Jefferson City, Missouri
September 2003

** **Denotes Highly Confidential Information** **

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BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Application of Aquila, Inc. For Authority to assign, Transfer, Mortgage or Encumber Its Franchise, Works or System	)))	Case No. EF-2003-0465

AFFIDAVIT OF JOAN C. WANDEL

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Joan C. Wandel, being of lawful age, on her oath states: that she has participated in the preparation of the foregoing Revised Rebuttal Testimony in question and answer form, consisting of 50 pages to be presented in the above case; that the answers in the foregoing Revised Rebuttal Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.

Joan C. Wandel

Subscribed and sworn to before me this 18th day of September 2003.

Toni M. Charlton
Notary Public, State of Missouri
County of Cole
My Commission Expires December 28, 2004

TONI M. CHARLTON
NOTARY SEAL
NOTARY PUBLIC
STATE OF MISSOURI

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REVISED REBUTTAL TESTIMONY

OF

JOAN C. WANDEL

AQUILA, INC.

CASE NO. EF-2003-0465

Q. Please state your name and business address.

A. Joan C. Wandel, P.O. Box 360, Jefferson City, MO 65102.

Q. By whom are you employed and in what capacity?

A. I am Regulatory Utility Manager for the Missouri Public Service Commission (Commission). As such I oversee and supervise the work of the Commission's Auditing Department.

Q. Please describe your educational background.

A. I attended the University of Missouri in Columbia, MO and received a Bachelor of Science degree in Home Economics with a major in Dietetics in 1968. I attended the University of Texas at San Antonio and received a Masters of Business Administration with a concentration in Accounting in 1977. In November 1978, I passed the Uniform Certified Public Accountant (CPA) examination and was licensed in the state of Texas in 1979 as a CPA. Since July 1981 I have been licensed in the state of Missouri as a CPA.

Q. Please describe your work experience.

A. I was employed by various certified public accounting firms from July 1979 through 1991, where I was responsible for the performance of audits and the preparation of financial statements and tax returns. From 1991 through 1993 I worked for the Affton

School District in St. Louis, MO as the Business and Budget Manager. Since 1994, I have been employed by the Commission as a Regulatory Utility Manager of the Auditing Department.

Q. Have you previously filed testimony before this Commission?

A. Yes. I filed testimony in the St. Louis Water Company rate case, Case No. WR-96-263.

Q. Have you made an examination and analysis of the books, records, data request responses and transcribed verbal answers of Aquila, Inc. (Aquila or Company) in regard to matters raised in this case?

A. Yes, in conjunction with other members of the Commission's Staff (Staff). I have reviewed the books, records, data request responses and transcribed verbal answers of Aquila in regard to matters raised in this case. I used these materials to evaluate Aquila's Application. I also relied on specific representations from my counsel that I will identify in my testimony. I evaluated the Company's request on an overall basis and coordinated with other Staff members that performed more detailed examination into specific areas related to the Company's request.

Q. What knowledge, skill, experience, training or education did you use to arrive at the conclusions expressed in your testimony?

A. I relied upon the education, experience and training detailed earlier in my testimony. I specifically relied upon my training and experience as a CPA to conduct my examinations of Aquila's request in this case and arrive at the conclusions that I will express later in my testimony.

Q. You mentioned above transcribed verbal answers as one source of information in this case. Please describe that process.

A. Staff, Office of the Public Counsel and Intervenors to this case interviewed Aquila representatives on July 16-18, 2003. The interview transcripts were a result of those interviews.

Q. Please describe the purpose of your rebuttal testimony.

A. The purpose of my rebuttal testimony is to respond to the Application and direct testimony of Aquila, Inc. On April 30, 2003, Aquila filed its Application and supporting testimony requesting approval for authority to "Assign, Transfer, Mortgage or Encumber its Franchise, Works or System." At paragraph 4 of that Application, the Company states that it:

> …requests a Commission order authorizing the assignment, transfer, mortgage or encumbrance of Aquila's utility franchise, works or system necessary or useful in the provision of regulated electrical, natural gas and heating company utility services to the public in Missouri in order to secure Aquila's financing arrangements which are used to support the Company's utility operations.

I will provide testimony setting out the general review of the Application and the conclusions reached by Staff. Specifically I will: 1) address the standard by which the Application was reviewed; 2) address the fact that this is not a traditional finance case; and 3) provide the overview and status of similar applications filed by Aquila in other jurisdictions. I will provide an analysis of the loan provisions related to the pledging of Aquila's Missouri assets. I will address Staff's position regarding Aquila's alleged working capital needs related to its Missouri utility operations.

Q. What other Staff witnesses are filing rebuttal testimony and what is the purpose of their testimony?

A. Ronald L. Bible of the Commission's Financial Analysis Department will testify to the validity of the financial safeguards proposed by Aquila in this case. James L. Ketter of the Commission's Energy Department will testify to the need to formalize current outage and reliability reporting during the period of Aquila's financial distress. Lena L. Mantle of the Commission's Energy Department will provide testimony regarding Aquila's current and future capacity resource needs that require the Company to maintain or have access to capital investment. J. Kay Niemeier of the Commission's Engineering and Management Services Department will address customer service quality concerns occurring during Aquila's current financial distress. She will propose reporting requirements to monitor this situation to reduce the probability that these concerns are not satisfactorily addressed. David M. Sommerer of the Commission's Procurement Analysis Department will address the impacts of the Company's financial condition on the natural gas procurement and supply process. He will also address certain working capital adjustments proposed by Aquila.

Q. How did Staff conduct this investigation?

A. Staff reviewed the various testimony and exhibits including the Application itself filed by Aquila relating to the Company's proposal to pledge utility assets for this financing. Staff submitted data requests, discussed data request with Company personnel during the review phase and conducted informal transcribed interviews.

The transcribed interviews occurred July 16-18, 2003, and included all of the parties to the case. The Company provided several individuals to answer questions posed by the

Staff and the other parties. The Company was allowed to review the transcripts for correctness and accuracy. To the extent Staff has used and relied on these transcribed interviews for purposes of this rebuttal testimony, the corrected versions were used.

Q. Is this is a typical finance case?

A. No. Unlike every prior finance case of which the Staff is aware, including those Aquila relies upon as precedent in its Application and direct testimony in this case, Aquila has already received the loan proceeds to which the requested encumbrance treatment would apply. In a typical finance case receipt of the loan proceeds is dependent upon Commission authorization. Further, to the extent that Aquila is seeking authority to encumber assets beyond the Term Loans' three-year period, this is also atypical as in the traditional financing case the applicant is seeking authorization limited to a particular transaction before the Commission.

DESCRIPTION OF THE LOAN FACILITIES AND ASSOCIATED ASSET COLLATERALIZATION

Q. Please describe the loan facilities Aquila finalized April 9, 2003.

A. Aquila finalized two different loans on April 9, 2003. The first is a $430 million three-year Term Loan Facility and Letter of Credit Facility (Term Loan). The second loan is a $100 million 364-day Term Loan. During the first 90 days, Aquila had the option to increase the face amount of this second loan to $200 million. The Company exercised this option June 2003. Aquila received the funds with regard to these loan agreements from a consortium of lenders and banks. This Application is only related to the three-year Term Loan. The $100/$200 million 364-day Term Loan is not relevant to the issues in this request.

Q. Please describe the asset collateralization provisions associated with the Term Loan.

A. Aquila issued First Mortgage Bonds Under Its Indenture of Mortgage and Deed of Trust, dated April 1, 2003, to Bank One Trust Company, N.A., Trustee, and its First Supplemental Indenture, dated April 9, 2003, to Bank One Trust Company, N. A., Trustee. The indenture and supplemental indenture represent a first mortgage lien on Aquila's assets described in the loan documents.

Q. Please describe the assets used to collateralize the Term Loan at closing.

A. Appendix 3 to the Application provides an execution copy of the $430 million three-year credit agreement, dated as of April 9, 2003. On page 9 of the direct testimony of Company witness Mr. Rick Dobson, he states:

> The $430 million term loan was secured with collateral from the Nebraska and Michigan domestic utilities, a pledge of the capital stock of the holding company of Aquila's Canadian utilities, and a silent 2nd lien on the equity interest in the holding company of Aquila's IPP investments.

Aquila represented that it did not need to seek regulatory authority from Michigan or Nebraska in order to pledge the utility assets in those states.

Q. What was the value of the assets pledged as collateral for the Term Loan?

A. According to the Schedule RD-2 attached to Mr. Dobson's direct testimony, the regulated assets totaled ** ______** million (Michigan ** ______ ** million and Nebraska ** _____ ** million); the Canadian assets were valued at ** ______ ** million; and the Independent Power Producers (IPPs) were valued at ** ____ ** million. These assets totaled ** ______ **million.

Q. What rate of interest is Aquila currently paying on the Term Loan?

A. Aquila is currently paying 8.75% per annum on $430 million. Aquila is paying $37.625 million of interest expense annually. If Aquila buys down the loan other than as required by its terms, there is a significant pre-payment penalty (see Section 2.7(a)(1) and the definition of "Make Whole Premium" in the loan agreement). The Term Loan does not have the features required to support utility working capital needs. The Term Loan does not allow the repayment of borrowed funds when cash is available to eliminate interest charges without a penalty charge.

Q. Why was it necessary for Aquila to file this Application?

A. The terms of the $430 million three-year credit agreement require the Company to make a "commercially reasonable effort" to seek necessary regulatory approvals to collateralize the domestic utility assets of Aquila. Section 5.13 Post-Closing Matters (a) identifies the terms of the loan that required regulatory approvals as follows:

> Post-Closing Matters. (a) Use its commercially reasonable efforts to, as promptly as practicable, obtain all necessary governmental and regulatory approvals (x) to add as additional property under the First Mortgage Indenture the tangible assets of each of the Borrower's operating divisions, to the extent necessary to cause the fair value of the Collateral Utility Business (including the fair value of such additional property (as evidenced by an appraisal dated within three months (or sooner if there has been a material adverse change affecting such additional property)) to be equal to or exceed 167% of the outstanding aggregate principal amount of First Mortgage Bonds then held by the Collateral Agent (such commercially reasonable efforts by the Borrower shall not require it or any of its subsidiaries to, among other things, (i) modify the conduct of its ordinary course of business in any material respect, (ii) divest itself of any significant assets or businesses, (iii) refund any amounts to any customers or (iv) reduce its rates or other charges to its customers) (once the Borrower shall have caused such additional property to be added and caused such ratio described in clause (x) above to have been first met, the Borrower shall have no further obligation to add additional property under this clause).

In response to this requirement the Company has filed Applications in the states of Missouri, Kansas, Iowa, Colorado and Minnesota. It should be noted that Aquila agreed with these lenders to collateralize its utility business value for the full outstanding balance (i.e., $430 million) and not limit the utility collateral to only the amount it determined necessary for its utility needs (i.e., $250 million as identified on page 10 of Mr. Dobson's direct testimony). Aquila agreed to provide these lenders utility collateral for amounts that the Company would use for non-regulated operations.

Q. Is it necessary for the Commission to grant approval of the Application in order for the Company to meet the terms of section 5.13 of the loan agreement?

A. It is the Company's position that the Commission need not grant approval of the Application for the Company to meet the terms of the loan agreement. This statement is supported by the following exchange:

> MR. FEATHERSTONE: If the commission does not grant approval in the state of Missouri or any other jurisdiction that is required, does that fit within the terms of section 5.13?
>
> MR. DOBSON: As long as we go through this process it does.
>
> [Source: July 16, 2003 Interview Tr., pp. 240 – 241]

Commission rejection of this application will not invalidate any Term Loan condition. Rejection of the application will not reduce the amount of funds available to support Aquila or any of its operations.

Q. Are there any benefits to the Company if it is able to collateralize the Term Loan with domestic regulated utility assets valued at no less than 167% of the outstanding aggregate principal amount of the First Mortgage Bonds?

A. Yes. If the Company is able to pledge utility assets at or exceeding the 167% of the outstanding loan balance, the Company will be able to reduce the $37.625 million of interest expense that it incurs annually by $3.225 million per year. The Company is currently paying 8.75% interest on the outstanding balance of the loan. This rate will decrease to 8.00% if the Company is able to pledge regulated utility assets with debt capacity value of at least $430 million.

Q. Is this level of interest expense related to Aquila's utility operations?

A. No. The Company is repaying and refinancing debt that it incurred unrelated to utility working capital needs with the Term Loan proceeds. This amount of interest expense is greater than the interest that would be charged to a normal utility operation. [Source: July 17, 2003, Interview Tr., p. 353, line 25 – p. 354, line 14]

Q. Since the Term Loan closed on April 9, 2003, have any additional utility assets been added as collateral to support the loan?

A. Yes. The Company reached an agreement with the Colorado Public Service Commission Staff. As a result of that settlement, the regulated assets in Colorado were appraised as of May 31, 2003, to have a value of ** ____ ** million. After applying the 60 percent loan value factor to the appraised value, the properties in Colorado have a debt capacity value of ** ______ ** million. This increases the value of the pledged regulated collateral to approximately ** ______ ** million and the total pledged collateral to ** ______ ** million. At this stage Aquila has more utility collateral supporting the Term Loan than is required to support its alleged working capital needs for its utility operations.

Q. Why did Aquila borrow the monies associated with the $430 million three-year Term Loan?

A. The Company borrowed the monies associated with the $430 million three-year Term Loan and the additional $100/$200 million 364-day Term Loan to replace a previously existing $650 million unsecured revolving loan that it had with a consortium of lenders, for which CitiBank acted as agent. When the Company's financial rating was reduced to less than investment grade status and violated certain interest coverage ratio covenants, it was necessary for the Company to seek a waiver from the lender group of the $650 million line of credit. As a result of this change of status, in September 2002 the Company sought an extension on the loan in order to obtain alternative financing. An extension of the loan was granted until April 12, 2003.

Q. What was the purpose of this $650 million revolving loan?

A. According to the information provided by the Company during the July 2003 interview, the monies were used to provide working capital to the various regulated and unregulated operations of the Company as well as provide funds for the short-term construction needs of those same operations.

Q. Is the new loan structured as a revolving loan like the $650 million loan it replaced?

A. No. The Company has borrowed the entire $430 million for a three-year term. Aquila used these monies to refinance the debt it incurred under the revolver. Aquila supports its working capital needs with cash maintained in its corporate level bank accounts and the Company "loans" these funds to the various operating divisions on an as-needed basis. The proceeds from the Term Loan were disbursed and are no longer in Aquila's corporate level bank account.

Q. Can you provide some history describing the events that lead to the financing transaction that requires Aquila to seek Commission approval in this case?

A. Yes. The Staff filed a report on the Company's financial status in December 2002. A copy of the report and the Company's comments in response are attached to this testimony as Schedule 1. This reports contains a detailed description of Aquila's history.

Q. Please provide an update of the significant events and their impact on the Company that have occurred since that December 2002 filing.

A. On November 19, 2002, Standard & Poors lowered the Company's credit rating to BB with a negative outlook. It previously had rated Aquila BBB-, its lowest investment grade rating.

On April 15, 2003, Aquila reported a fully diluted loss of $5.22 per share for the fourth quarter of 2002, or a net loss of $977.9 million on sales of $411.3 million for the quarter. The Company stated that the loss in the fourth quarter was due to impairment charges, losses within discontinued operations and margin losses on winding down Aquila's merchant trading portfolio.

The Company also reported a fully diluted loss of $12.83 per share for the calendar year 2002 on sales of $2.4 billion for that year. The Company stated that restructuring charges, impairment charges and net losses on sales of assets, losses within discontinued operations and margin losses incurred during the wind-down of Aquila's merchant trading portfolio contributed to the majority of the 2002 net loss.

On May 13, 2003, Aquila announced that it had terminated the 20-year tolling agreement for Acadia Power Partners, LLC. Under the toll, Aquila supplied the natural gas to a combined cycle plant in Eunice, Louisiana, and paid fixed capacity payments for the right to sell into the wholesale market 580 megawatts of power generated by the plant. Under the termination agreement, Aquila paid Acadia $105.5 million to release Aquila from the agreement. The transaction returned $45 million to Aquila in posted collateral and eliminated $843 million in payments due Acadia over the remainder of the 20-year term. Aquila entered into the contract with Acadia in 2000.

Aquila's financial status during the first quarter of 2003 continued to reflect the costs of winding down its wholesale energy trading business, while also seeing improved results from its domestic utility networks. On May 15, 2003 Aquila reported a fully diluted loss of $.27 per share for the first quarter of 2003, or a net loss of $51.9 million on sales of $579.3 million. The loss was attributed to: 1) trading and contract losses related to last year's decision to exit the energy trading business; 2) an increase in fixed capacity payments for merchant generation capacity; 3) mark-to-market losses on certain long-dated forward contracts; and 4) higher interest cost reflecting additional borrowings and higher interest rates due to the Company's non-investment grade credit rating. The Company also reported $6.3 million in restructuring charges primarily connected with unfavorable interest rate swaps.

On May 22, 2003, Aquila announced that, along with its partner, FirstEnergy Corp., it had reached an agreement to sell their respective shares of Sterling Limited for 43 million pounds. Aquila owned 79.9% of the joint venture.

On July 10, 2003, an agreement reached between Aquila and the Colorado Public Utility Commission Staff became effective. This agreement allowed Aquila to pledge Colorado's regulated utility assets as collateral to the three-year Term Loan.

On July 24, 2003, Aquila sold its Australian properties. The Company announced that it would receive approximately US $477 million from the sale or about US $32 million higher than originally anticipated. This increase was mainly attributed to the stronger Australian dollar.

On August 12, 2003, the Company reported net losses for the second quarter 2003 of $80.6 million or $.41 per fully diluted share. Mr. Richard C. Green, Aquila's chairman and chief executive officer, stated: "We will continue our restructuring through this year and next, especially our work to address our remaining long-term gas contracts and fixed capacity payments for merchant power plants." The second quarter loss is considered to be due primarily to restructuring and impairment charges related to last year's decision to reshape the business to a regulated utility. Both operating cost and interest expense were higher in 2003 due to the Company's non-investment grade credit.

The Company is presently in the process of seeking and evaluating proposals with regard to the sale of its Canadian properties.

No additional investment rating downgrades have occurred since November 2002. [Source: http://www.aquila.com, News & Events, September 9, 2003]

Q. Could you describe Aquila's corporate structure?

A. Schedule 1 to this rebuttal testimony includes a discussion of Aquila's corporate structure, as was identified in the report generated by Staff December 2002. Aquila is not a holding company and its operating divisions or departments are legally indistinguishable from Aquila, Inc. As such, its utility operations are not separate corporate entities and cannot issue stand-alone debt. Aquila's corporate structure is that of a company where all the regulated, non-regulated and parent activities are performed within divisions or departments within the same overall company.

CONCLUSIONS AND RECOMMENDATIONS

Q. What is the Staff's recommendation regarding Aquila's request to encumber its Missouri assets?

A. The Staff recommends that the Commission reject the Application, because granting this action would be detrimental to the public interest. While Staff is unsure of the appropriate standard that applies to the unique features of this case, Staff bases its recommendation on the least onerous standard that Staff has seen applied by the Commission to past finance, merger and sale cases. Pledging Missouri's assets to a completed financing transaction that does not require such a pledge as a condition for receipt of the funds is a detriment to the operations of Aquila's Missouri properties. The use of Missouri properties as collateral for an existing loan will diminish the capability to use these assets for collateral in the future to support Missouri operations in the event such funds are needed. Currently, the Missouri operations have limited access to capital as a result of their association with Aquila's non-regulated endeavors. The capital raising potential of the Missouri properties should not be squandered on a transaction that will raise no funds for Missouri operations. This capital raising potential should be maintained in the event that it is needed to be used to provide future funds to support electric and gas service in Missouri.

Q. What are the bases for Staff's recommendation?

A. Staff's recommendation to reject Aquila's Application is based on the following seven factors:

1) Approval of the Application will not result in Aquila receiving any additional funds to be used for its Missouri operations. In addition to closing the loan, Aquila has already spent the $430 million it received from the Term Loan. This Application is a post-closing requirement for Aquila to use "commercially reasonable efforts" to get approval to increase the collateral supporting the loan. Approval of Aquila's Application would result in the Missouri properties being available as secondary, junior or subordinate collateral in the future.

2) Rejection of the Application will leave Missouri's assets available for use in future financings when the proceeds are earmarked to support the cash needs of Missouri-regulated operations.

3) Using Aquila as the only resource for the working capital needs of Missouri's regulated operation is detrimental to the public interest because there is no guarantee that monies will be available when needed by the utilities. Previously, the Company had several means of raising cash when needed. The Company is now restricted to whatever cash it has on hand. The funds to support the working capital needs for Aquila's utility operations in the United States (US) are the cash balances maintained by Aquila's Treasury Department. Aquila's US utility working capital needs can no longer be supported by lines of credit or the ability to sell commercial paper because of their association with the financial consequences of Aquila's non-regulated operations. If secured financing is used to support Aquila's regulated working capital needs, there is no certainty that the funds will be available if and when the utility operations actually need the funds. Lines of credit or commercial paper sales are the most efficient method to address working capital needs since monies are only borrowed as needed and interest is paid only for the amount of money

borrowed for the time the loan is outstanding. Aquila used a revolving line of credit to provide its working capital needs prior to its loss of investment grade status. The Term Loan provided funds to pay the debt incurred under the revolver. The Term Loan does not provide funds to support any of Aquila's current working capital needs. Aquila must maintain enough cash in its bank accounts to address all its working capital needs. Secured financing is an inefficient method to support the working capital needs of Aquila's US utility operations in general and Missouri's regulated operations specifically. This is because Aquila is paying interest expense for funds when they are not being used to support the US utility operations. Therefore, Aquila's cash balances are reduced by these unnecessary interest expense levels.

4) Aquila overstates it utility working capital needs as a result of its internal money transfer program, which permanently extracts utility funds to pay the obligations of its non-regulated operations. The Company classifies these money transfers as "internal dividends" despite the fact that it does not pay dividends to its shareholders and its US utilities are operating divisions, not separate legal entities. These money transfers or "internal dividends" should be retained by Aquila's US utility operations, thereby reducing regulated working capital needs.

5) Aquila already has authority to encumber more utility assets (Nebraska, Michigan and Colorado) than is required to support the $250 million working capital needs it asserts are necessary to support its utility operations. Additional utility collateral commitments provide existing lenders more security for the Term Loan without providing any additional capital or certainty of the availability of these funds for the actual working capital or construction needs of Aquila's utility operations. Additional utility

collateral only supports the portion of the Term Loan that Aquila has designated for its non-utility operations.

6) It is detrimental to the public interest and unfair to consumers for Missouri operations to have to encumber a disproportionate amount of its capital assets relative to its working capital needs. Missouri is being requested to pledge its assets, which are largely related to electric activities, as additional security for the Term Loan to support Aquila's working capital needs, which are primarily driven by its gas operations. It is unfair to Missouri consumers to encumber Missouri's assets when they are already paying the costs for the revolving lines of credit needed to support Aquila's working capital needs through existing rates.

7) Using utility assets to obtain the 75 basis point reduction in interest from 8.75 to 8.00 percent requires Aquila's utility operations to commit more collateral than that required to support the Company's asserted utility working capital needs. Annually, the Company will pay $37.625 million of interest expense on the Term Loan. Internally the Treasury Department charges the utility operating divisions an annual rate of 3.148% on funds advanced for the number of days outstanding. This over-collateralization of the Term Loan only benefits Aquila's non-regulated operations by reducing the **annual** interest by $3.225 million or reducing the amount of annual interest expense to $34.4 million. This will not result in a significant reduction in Aquila's overall annual interest expense payments. Aquila reported $76.9 million of interest for the second **quarter** of 2003. This equates to a level of interest expense that exceeds $300 million annually. The 75 basis point reduction and the resultant interest rates stated above are not the result of Aquila's utility operations. The 75 basis point reduction and the resultant interest are the result of Aquila's non-regulated

ventures. The 75 basis point reduction and the resultant interest do not represent the normal, on-going operations of an investment grade utility. Aquila's Treasury Department will charge the utility operations for its loans. A 75 basis point reduction in the Term Loan interest rate will not reduce the rate Aquila charges the utility operations for its loans. The only beneficiary of the interest rate reduction will be Aquila's non-regulated operations in spite of the fact that utility assets are used to achieve the interest expense reduction.

Q. Is Staff proposing any conditions at present in the event the Commission approves this Application?

A. No. It is Staff's position that the Company's proposal is so flawed it cannot provide the conditions necessary to recommend that the Commission approve this proposal in any fashion. Missouri needs to maintain the full extent of its ability to raise capital to protect its Missouri utility operations from the potential threat caused by its association with Aquila's failed non-regulated activities.

STANDARDS APPLIED TO THIS APPLICATION

Q. What standards generally apply to finance cases?

A. Aquila's Application relies upon statutory provision Sections 393.180 and 393.190.1, RSMo 2000, that contain no review standards. Additionally, it relies on a Commission Rule, now codified at 4 CSR 240-3.110, which references the standard of "not detrimental to the public interest" in connection with the sale of assets. Generally, upon advice of counsel, there are three standards which apply to typical finance cases. In order for a company to issue stock, bonds or debt the proceeds must be "reasonably required" for the operation of the company. With regard to the acquisition of assets, the assets being purchased must be "necessary and reasonable" to the provision of utilities to the customers. The third standard is that the transaction must be "not detrimental to the public interest."

The standard of "reasonably required" does not apply to this situation in that the debt issuance has already occurred. This standard is found in Section 393.200.1 RSMo, which states:

> …that there shall have been secured from the commission an order authorizing such issue, and the amount thereof, and stating the purposes to which the issue or proceeds thereof are to be applied, and that, in the opinion of the commission, the money, property or labor to be procured or paid for by the issue of such stock, bonds, notes or other evidence of indebtedness is or has been **reasonably required** for the purposes specified in the order, and that except as otherwise permitted in the order in the case of bonds, notes and other evidence of indebtedness, such purposes are not in whole or in part reasonably chargeable to operating expenses or to income. [emphasis added]

The Company structured the loan in such a way that the actual loan did not require Commission approval in that the loan was made to Aquila, Inc., which is a Delaware Corporation. It is my understanding, upon the advice of counsel, that this makes Aquila a "foreign corporation" and, as such, Aquila did not need approval from the Commission for this debt issuance.

The second standard, "reasonable and necessary," also does not apply in this situation since the proceeds from the loan have already been received and put into use by the Company. This standard is established in Section 8393.220.1 RSMo states:

> The commission shall have power to require gas corporations, electrical corporations, water corporations and sewer corporations to account for the disposition of the proceeds of all sales of stocks, bonds, notes and other evidences of indebtedness in such form and detail as it may deem advisable, and to establish such rules and regulations as it may deem **reasonable and necessary** to insure the disposition of such proceeds for the purpose or purposes specified in its order. [emphasis added]

The use of Missouri's assets is neither reasonably required nor reasonable and necessary since the loan already exists and funds have been disbursed.

The Staff considers the third standard, "detrimental to the public interest," to be the easiest of the three standards for the Company to meet and the most difficult of the three for the Staff to disprove. All the Company must do is show "no harm" to the ratepayers. The Staff, on the other hand, must prove that the ratepayers have been harmed in some manner to cause the Commission to decide against the Company's request. The burden is upon the Company to demonstrate there is no adverse effect to customers with respect to its request, while the burden is upon those reviewing the request to challenge the Company's claim.

Q. What standard did the Staff use to develop its recommendations regarding this Application?

A. Although Aquila is not seeking to sell assets, Staff used the standard of "detriment to the public interest." If the Company fails to show that pledging of assets is not detrimental to the public interest in Missouri, i.e., if it has not demonstrated that the proposed pledging of assets will not harm the Missouri public, then the Commission should reject this Application. Staff counsel has advised that the "not detrimental to the public interest" standard is based on case law generally cited in Commission Orders, such as <u>State ex rel. City of St. Louis v. Public Serv. Comm'n</u>, 73 S.W.2d 393 (Mo.banc 1934); <u>State ex rel. Fee Fee Trunk Sewer Co., Inc. v. Litz</u>, 596 S.W.2d 466 (Mo.App. 1980). The standard also appears in 4 CSR 240-3.110, the Commission's rule that addresses particular filing requirements for authority to sell, assign, loan or transfer assets.

Q. How is Staff defining the term "public?"

A. Consistent with Staff's position in other cases, it views the members of the "public" that must be protected in considering this Application as those consumers taking and receiving utility service from Aquila's electric, natural gas and industrial steam operations in the State of Missouri.

In this case, Staff would define "public interest" as referring to the nature and level of impact or effect that the pledging of Aquila's Missouri utility assets will have on its Missouri customers. This includes Aquila's electric, natural gas and industrial steam customers in Missouri. There is a fundamental concern in the regulation of public utilities that the public being served must not be impacted adversely or harmed by those responsible for providing monopoly services. Public utilities in Missouri are charged with providing safe and adequate service at nondiscriminatory, just, fair and reasonable rates. As part of this charge, the utility's assets must be protected to ensure the continued service to the utility's customers. If this Application results in adverse or negative impacts to Aquila's Missouri electric, natural gas and/or industrial steam customers, then the Commission should not approve the Application.

In the merger case involving Kansas Power and Light (KPL) and Kansas Gas Energy (KGE) in 1991, the Commission identified the "public" as Missouri ratepayers. At pages 12 and 13 of its Report And Order (Case No. EM-91-213), the Commission stated the following:

> The Commission has found no evidence in this record that KPL would be unable to render safe and adequate service to its Missouri ratepayers as a consequence of the proposed merger. However, the Commission has found that the savings sharing plan proposed by KPL as part of its merger application has the potential of exposing Missouri ratepayers to higher rates than would be the case without the merger, which would be **detrimental to the public interest** ….

> The Commission has also found that there is potential for a **detrimental effect on Missouri ratepayers** from the merger through increased A & G and capital costs ….
>
> Based upon these finding and determinations, the Commission concludes that Missouri ratepayers will be shielded from any potential ill effects from the proposed merger and will suffer **no detriment** as a result. Therefore, the Commission concludes that, in the absence of a finding of **detriment to the public interest**, it may not withhold its approval of the proposed merger and will authorize KPL to acquire and merge with KGE. [emphasis added]

Clearly, the Commission was identifying the Missouri ratepayer as the relevant "public" in this Report And Order. This is the standard that is being applied to this Application.

Q. Is Staff defining "detriment to the public interest" differently in this case than it has in previous cases?

A. No. Staff is using the same definition for the standard and is basing its evaluation of this Application on the same detriment standard as it has in previous cases.

SUPPORT FOR STAFFS' CONCLUSIONS AND RECOMMENDATIONS TO NOT PLEDGE MISSOURI ASSETS TO SUPPORT THE TERM LOAN

SECTION 1: NO ADDITIONAL FUNDS

Q. Why does Staff believe the fact the loan has already been processed supports Staff's opposition to this Application?

A. In review of this Application, it is the Staff's understanding that the Company is seeking the Commission's approval to encumber assets to support a financing made in April 2003. The Staff believes this is not a standard finance case wherein the Company would seek pre-approval of the financing. Because the Company is a "foreign corporation," it did not need to seek Commission approval to execute the loan. The Company, through its execution of the $430 million three-year Term Loan, dated April 9, 2003, effectively caused the loan to occur and the Company received the $430 million amount.

The terms of the loan agreement do not require the pledging of Missouri's regulated assets. Therefore, the Commission need not approve the Application for Aquila to fulfill the terms of the loan agreement.

Q. Did the Company indicate to the lenders that it would seek Commission authority to pledge Missouri assets as additional security to this loan agreement?

A. Yes. As part of the loan agreement for the $430 million three-year Term Loan, the Company committed to seek permission to pledge Missouri's assets. Appendix 3 to the Application, Section 5.13 <u>Post-Closing Matters</u> identified the commitment by Aquila to its lenders to seek approval to pledge these assets. Aquila committed to:

> …[u]se its commercially reasonable efforts to, as promptly as practical, obtain all necessary governmental and regulatory approvals (x) to add as additional property under the First Mortgage Indenture the tangible assets of each of the Borrower's operating divisions, to the extent necessary to cause the fair value of the Collateral Utility Business … to be equal to or exceed 167% of the outstanding aggregate principal amount of First Mortgage Bonds then held by the Collateral Agent …

Q. Has Aquila fulfilled this part of the loan agreement?

A. Yes. By applying for Commission approval to pledge its Missouri-regulated assets and making a reasonable good faith effort to obtain that approval, Aquila has fulfilled this part of the loan agreement.

Q. Please describe why the Company will receive no additional funds if it receives approval from the Commission and, consequently, pledges Missouri's assets as additional security to this loan?

A. The Company has already closed, received and expended the entire amount of the loan. The amount to be borrowed was capped at $430 million. As indicated during the July 17, 2003 interview, the Company indicated it was limited to the $430 million amount by the Federal Energy Regulatory Commission (FERC) capacity authorization [Source: July 17, 2003, Interview Tr., pp. 566, l. 5 – 567, l. 21]. The loan is currently secured by other regulated and non-regulated Aquila assets. Adding Missouri's regulated assets would only provide additional security to the lender. It would not make additional funds available for Aquila's use. Pledging Missouri's regulated assets encumbers those assets without providing any benefits to either ratepayers or the Company.

It should be noted that the Aquila's FERC authorization predates the Agency's Westar order, which established a new FERC precedent to provide additional safeguards for utility operations from a company's non-regulated operations. A copy of the FERC order in the Westar case is attached to this testimony as Schedule 2.

SECTION 2: MAINTAINING MISSOURI ASSETS FOR FUTURE FINANCING NEEDS

Q. Do the Company's Missouri operations require any capital expenditures in the future?

A. Yes. As addressed in the testimony of Staff witness Mantle, Aquila will need to address capacity expansion requirements sometime within this decade. By not pledging Aquila's Missouri assets, it leaves those assets available to address future financing needs that Aquila has indicated will be required. Clearly it is in the interest of Missouri's customers to have sufficient and reliable capacity. To the extent that lenders require security for financing assets (such as generating facilities) then that would directly benefit Aquila's

Missouri customers. To encumber assets unnecessarily would not be sound regulatory policy and would shortchange Aquila's customers in the long run. Rejecting this Application provides the required flexibility to allow Aquila, even if it continues to be financially impaired in the near term, to raise the necessary capital that will be needed to meet its future obligations to supply electric, natural gas and steam to customers in this state.

SECTION 3: WORKING CAPITAL

Q. Does the Term Loan contain the features that Aquila traditionally uses to support the working capital needs of its Missouri properties?

A. No. Traditionally Aquila supported its working capital needs for its Missouri operations though the use of either a revolving loan (a/k/a letter of credit) or by issuing commercial paper. With a traditional line of credit, Aquila borrowed monies on an as-needed basis rather than incurring interest against an outstanding loan that may or may not be for the correct amount of needed funds. For example, while the Company has borrowed funds through the Term Loan based on a worse case scenario of high gas prices ($11.63 / MMBtu) and severe weather, these loans may be unnecessary if those circumstances don't materialize. The Company borrowed money under the Term Loan to refinance the debt incurred under the prior revolving loan. Aquila has no funds from the Term Loan to support its current working capital needs.

Q. Why does Staff believe that the Term Loan funds do not support the utility's working capital needs?

A. The Term Loan funds were used to refinance the debt incurred from prior transactions. The Term Loan does not provide additional funds to Aquila. The Term Loan is not designed to address Aquila's working capital needs. It is inefficient and ineffective to use secured debt financing for working capital needs. Working capital needs are usually served through either an unsecured revolving line of credit or the sale of commercial paper. This allows the monies needed for working capital to be borrowed on an as-needed basis. The need to encumber Missouri's regulated operations should be reserved for situations where infrastructure investments are needed to support expansion. Encumbering Missouri's regulated assets deprives the Missouri ratepayers of the opportunity of using these assets as collateral in the future and is therefore "detrimental to the public interest."

Q. Why was it necessary for Aquila to seek this type of financing arrangement rather than use a traditional line of credit or commercial paper for working capital needs?

A. The Company could not obtain traditional sources for working capital funds due to its weakened financial condition. As a result of the losses incurred by its non-regulatory operations, the Company sustained several financial credit downgrades, which in turn made them less creditworthy in the eyes of the financial world. Also, as a result of these credit downgrades, the Company failed to meet interest coverage covenants on the existing $650 million revolving line of credit it had in existence to support its working capital needs. Failure to maintain interest coverage made the revolver debt payable on the demand of its lenders. Hence, Aquila was forced to seek permanent financing in the form of this $430 million three-year Term Loan to raise the funds needed to repay the debt incurred under the revolver loan. The Term Loan provides no funds to pay any future expenditures related to Aquila's future working capital needs.

Q. Are there benefits to Aquila and its Missouri customers if Missouri assets are not pledged in relation to the current $430 million credit agreement?

A. Yes. Since the Company will receive no additional funds by approving this Application, it is unnecessary to pledge Missouri assets for this loan. Rejection of this Application provides flexibility in the future by leaving the assets unencumbered and available as collateral should the need arise.

Q. What amount has the Company identified as its working capital needs of its regulated utilities?

A. Aquila identified a working capital amount of $250 million for its regulated operations. This amount was derived by an internal study performed by the Company. The $250 million was determined on an overall basis for domestic regulated utilities and not on an operational or jurisdictional basis.

Q. Where are the funds for the US utility working capital needs maintained?

A. The funds for the US utility working capital needs are maintained in the overall cash balance of Aquila's corporate account managed by its Treasury Department. This account is used for payment of regulated and non-regulated expenditures including working capital needs.

Q. Does the Company have any safeguards in place on this account to ensure that the $250 million amount will be available for its utility working capital needs?

A. No. The Company has made no provision to separate or segregate these monies by regulated and non-regulated operations. In addition, the Company has made no provision to dedicate these monies by state jurisdiction or utility type (e.g., gas, electric or steam). The Company has stated that it is committed to safeguarding the $250 million for use by its domestic regulated utility operations but has adopted no other safeguards to ensure that either a specific amount of working capital will be set aside for each state jurisdiction based on the estimated jurisdictional working capital needs, or a specific amount set aside for the use of each state jurisdiction based on the pro-rata values of assets pledged as collateral for this loan.

Q. What guarantees does the Company have in place to ensure that the monies "borrowed" from the corporate account for non-regulated purposes will not exceed $180 million identified on page 10 of Mr. Dobson's direct testimony as the amount needed by Aquila for its non-regulated working capital needs?

A. None. In fact, given the cash needs of the non-regulated operations (e.g., $130 million annually for prepaid gas contracts), it is likely that the non-regulated operations will exceed the amount of $180 million in borrowings.

Q. Is the Company asking that all of Missouri's regulated domestic assets be pledged to this loan?

A. Yes. The Company is asking that all of Missouri's regulated domestic assets be pledged to this loan.

Q. What reason did the Company give for pledging 100% of Missouri's regulated assets rather than only the pro-rata share of the assets?

A. In response to Staff Data Request No. 26, the Company stated: "In order to have any value, the underlying collateral must represent a functioning business, or going concern."

Q. What reason did the Company give for pledging regulated utilities as collateral for this loan?

A. According Mr. Dobson's direct testimony (p. 11), the Company believes it is only fair to pledge all regulated utility assets since the $250 million working capital portion of the loan is needed to support the day-to-day operations of all of Aquila's utility operations. Staff disputes the assertion that the Term Loan supports the day-to-day operations of all of Aquila's utility operations.

Q. In the Staff's opinion is it fair to the Missouri ratepayers to pledge 100% of Missouri's assets as collateral for this loan if the Commission finds that the Term Loan does support the day-to-day operations of all of Aquila's utility operations?

A. No. First, Missouri regulatory assets far exceed the value of assets located in any of the other states in which Aquila operates. According to Schedule RD-2 attached to Mr. Dobson's direct testimony, for purposes of collateralizing this loan, Missouri's regulated assets represent approximately ** ______ ** million of a total regulatory asset pool of ** ____ ** billion or ** ______ **. Fairness would seem to dictate that every state would be required to provide collateral not in excess of its working capital needs to the extent each state is comfortable using secured financing to support such needs.

Second, the Company has provided no evidence that Missouri is a net user of working capital funds. The working capital model as produced by the Company to support the $250 million amount, the results of which are attached to this testimony as Schedule 3, indicates that Missouri was the only state Aquila operates in that did not require working capital and, in fact, was a net provider of cash.

Third, the alleged working capital needs of the Company are greatly exaggerated. The Company has sworn to protect the ratepayers from the costs associated with its lowered investment grade status. The utility operations are creditworthy and should be allowed the normal grace period to pay for goods and services after receipt of those goods and services. Aquila's utilities now must prepay almost all goods and services because of their association with the Company's poor financial standing. In particular the Company is required to prepay for gas supply for its Local Distribution Companies (LDCs) and for its electric operations, as well as, prepay for purchased power. These are two of the key factors in calculating the overall working capital needs for the regulated utilities. The $250 million working capital amount included the costs associated with the prepayment for gas and purchased power. The Company, by requiring its utility operations to provide collateral to support these additional costs, has failed to protect and safeguard the regulated utilities from the fallout of its poor financial standing. This is an example of how the working capital needs for the utilities are overstated. The costs of prepayment of these goods and services should be absorbed at the corporate level, not at the utility level. Utility assets should not be used to support the excess working capital needs forced upon the utilities due to a corporate structure that failed to shield the utilities from the adverse results from non-regulated activities.

Q. Has the Company developed a working capital requirement for its Missouri operations?

A. Yes. Aquila, has developed a working capital amount for its regulated operations. This analysis showed that Missouri was the only state that did not require working capital at the time of the peak working capital needs for the utility operations. In response to Staff Data Request No. 75 attached as Schedule 3 to this testimony, the Company provided the working capital model and the underlying assumptions used to develop the working capital amounts for each jurisdiction. As can be seen on Schedule 3, Missouri is the only state that has a negative working capital amount. The model results show the following Peak Working Capital Need by State:

State	Net Working Capital
Colorado	** __________ **
Iowa	** __________ **
Kansas	** __________ **
Michigan	** __________ **
Minnesota	** __________ **
Missouri	** __________ **
Nebraska	** __________ **
Other	** __________ **
Total	$244,626,783

Q. What percentage of working capital needs does Missouri represent?

A. Using the numbers provided by the Company on Staff Data Request No. 75, the original working capital model showed that Missouri had a negative ** _____ ** of the peak working capital needs. The Company's working capital model calculated Missouri's working capital needs as a negative ** ____ ** million for January 2004. Missouri is actually shown to be a net positive cash flow provider. It was only after the Company took those initial calculations and made additional adjustments that it was able to state on page 11 of Mr. Dobson's testimony that all of its regulated operations needed the loan to provide necessary working capital for operations.

The Company, through its analysis, identified additional working capital needs beyond the analysis that they asserted would result in a positive working capital amount for Missouri's regulated operations. These adjustments resulted in Missouri's working capital needs being changed from a negative ** ____ ** million to a positive ** _____ ** million. [Source: Wandel rebuttal, Schedule 3]

Q. Did Aquila develop a requirement for each of it state operations?

A. No. In response to Staff Data Request No. 75, Aquila indicated that it developed a working capital requirement on an overall regulated utility basis rather than state by state. However attached to that Data Request is a schedule that provides the amounts the Company has identified as needed on a state-by-state basis.

Q. How did the Company develop the overall working capital requirement for the utilities?

A. Aquila's working capital model was developed using "the Company's overall cash needs peak in the winter, primarily driven by gas purchased for distribution. Missouri's gas and electric operations represent a portion of this peak" (Staff Data Request No. 75 attached as Schedule 3 to this testimony). The analysis was done using the peak month of January 2004 estimates. Since this is a winter month, the working capital amount developed by using this model was primarily driven by the gas distribution operation. Missouri's gas distribution operations are relatively small (i.e., less than 6%) in relation to Aquila's regulated gas operations in the other states. Therefore, the working capital amount is primarily driven by other states.

Q. What assumptions did Aquila use in developing the model?

A. To develop the working capital requirement, Aquila made the following assumptions:

1. Gas would be prepaid for all LDC and electric operations.
2. Purchased power would be prepaid for all electric operations.
3. Gas was stress tested at $11.63 per MMBtu.
4. 10% increase in volumes of gas purchases.
5. All cash receipts were modeled based upon the revenues from the 2003 through 2005 budgets.

Q. What additional adjustments were used to modify the model results for Missouri operations?

A. The Company included: 1) the Missouri Purchased Gas Adjustment (PGA) which was based on February 2001; 2) underbilled budget billing based on February 2001; 3) a Missouri ice storm that last occurred in January 2001; 4) the January 2003 coal supply purchases; 5) a December 2002 coal supply purchases prepayment scenario; and 6) the January 2003 capital expenditures. The estimated peak, when added to the negative ** ____ ** million determined by the model, resulted in a positive ** _____ ** million adjusted working capital need for Missouri. [Source: Wandel rebuttal, Schedule 3]

Q. Please describe the modifications there were made to the Company's original working capital analysis for Missouri?

A. The Company made several adjustments to Missouri's peak working capital need calculation that resulted in a ** _____ ** million positive working capital need. Although these adjustments are outside the model, we compared this amount to the original total working capital as computed by the model. This computed to ** ____** of that total. It should be noted that the modifications made to Missouri's working capital model results as performed by the Company would, in all likelihood, also apply to the other states as well and would cause the working capital percentage for Missouri to be reduced. The Company did not make similar adjustments to the model's outcomes for the other states. This, in effect, skewed the results attributed to Missouri operations. For example, Missouri's working capital needs were increased by $2.7 million for January 2003 construction expenditures when the Company noted in the transcribed interview (p. 650) that monies needed to finance construction programs were excluded from the calculation of the maximum utility working capital needs.

The post-model adjustments that increase Missouri's working capital needs conflict with the model's basic assumptions. For example, an adjustment is made for an ice storm in January 2004. However, ice storms occur at temperatures that are warmer than the temperatures used by the model to create a 10% increase in volumes of gas purchases. If an ice storm occurs creating working capital needs, then the needs would be offset by the reduction in working capital caused by a reduction in gas volumes purchased as a result of the warmer temperatures causing the ice storm.

Q. Does Staff agree with the working capital amount developed by Aquila for the Missouri operations?

A. No. The Staff believes that the working capital needs for Missouri are overstated based on the assumptions applied to the model and the additional adjustments applied to the model outcome for Missouri. These assumptions and adjustments, such as the prepayment of gas supply and purchased power, include amounts that would not be necessary were it not for the fact that Missouri's operations are associated with the Company's non-regulated activities and their negative consequences. The inclusion of such assumptions and adjustments inflates the calculated working capital needs associated with Missouri's regulated operations. Aquila has asserted the Term Loan proceeds support the utility working capital needs. They do not. However, in order to justify the pledging of Missouri assets to this loan the Company has: 1) asserted a relationship between the Term Loan and the utility working capital needs; and 2) overstated the working capital needs for the regulated utilities because of their relationship with Aquila's non-regulated financial losses.

During the July 16, 2003, interview [Source: July 16, 2003 Interview Tr., p. 245, ll. 12 - 18] the following comments were made:

> MR. SCHALLENBERG: And you mention under an investment grade scenario. Are you saying that by not being investment grade makes the working capital requirements of the utilities greater?
>
> MR.DOBSON: It does.
>
> MS. ARMSTRONG: Yes, it does.

On page 247 of that transcript [Source: July 16, 2003 Interview Tr., p. 247, ll. 11 - 16] in response to a query by Mr. Sommerer regarding the effects of a lower investment grade status on the working capital needs, Mr. Dobson stated: "As a non-investment grade company, they require us to prepay for the commodity up front before flow, which causes a significant delay in the payment for the commodity in the billing cycle and collection of those bills."

Q. Are there any other items included in the working capital model that cause the results of the model to be overstated?

A. Yes. The Company included several items in its working capital calculation that caused the results to be overstated. The Company estimated its working capital needs using a worse case scenario, including a very severe winter, extremely high gas prices, winter storms, etc. The application of these assumptions inflates the need for working capital by the utilities. Since the Company has no other resources for working capital, it was forced to maintain cash on hand rather than use a revolving letter of credit or issuing commercial paper to meet its working capital needs. While the Staff understands that all companies have working capital needs, the Staff does not agree that Missouri assets should be pledged in the event Missouri's working capital needs are increased because of an association with the

Company's downgraded financial position and its inability to use efficient methods to address these needs. Had the Company not suffered such losses on its non-regulated side, it would have been able to borrow money through the traditional methods of financing working capital without any condition to pledge its Missouri assets.

Q. How will the Company's regulated Missouri customers be harmed if Missouri assets are pledged because Aquila has unnecessarily increased Missouri's working capital needs and cannot support these increased cash needs through normal methods?

A. The Company's Missouri operations will need financing for new infrastructure/new capacity in the near future. Any assets that are unnecessarily encumbered today reduce the amount of capital that these assets can raise in the future. This benefits neither the Company nor its Missouri customers.

Q. Has Staff reviewed the working capital needs of Missouri-regulated operations independent of the negative consequences of being associated with Aquila's non-regulated ventures?

A. Yes. Typically in a major rate case, Staff examines the working capital components of the utility including cash working capital (CWC). In each of Aquila's past rate cases, including those filed under its former name UtiliCorp United, Inc., Staff reviewed the working capital requirements that should be included in rates. Each of those analyses resulted in a negative cash working capital component being included in rates. The last general rate case filed by Aquila in Missouri was Case No. ER-2001-672. Staff performed a lead/lag study that identified the cash working capital requirement for Aquila as a negative $20.9 million. In addition, the allowances for customer advances and customer deposits in that case amounted to $5.7 million. Those items are a source of cash and can be used by the

Company for cash needs. Customers provided a total of $26.6 million from the above items, an amount sufficient to fund expenditures for materials, supplies, fuel inventories and prepayments all of which are uses of cash and totaled $22.9 million in Case No. ER-2001-672. The above amounts are all calculated on a Missouri jurisdictional basis [Source: Staff's revenue requirement runs in Case No. ER-2001-672, filed December 2001, Accounting Schedules 2 and 8]. These sources of customer funds would offset the Company adjustments for the January 2003 coal supply purchases and a December 2002 coal supply purchases prepayment scenario.

Q. What is cash working capital as you used the term in your previous answer?

A. Cash working capital is the amount of cash necessary for a Company to pay the day-to-day expenses incurred to provide utility service to Aquila's customers.

Q. How has the Staff historically determined the cash working capital needs of the Company?

A. The Staff has historically determined the Company's cash working capital needs through a lead/lag study. A lead/lag study determines the number of days it takes the Company to receive payment for service it provided to its customers. A led/lag study also determines who provides the cash working capital.

Q. What are the sources of CWC?

A. Shareholders and ratepayers are the potential sources of CWC. Shareholders are the provider of cash working capital when the Company pays for an expense before the ratepayers provide the cash. Ratepayers are providers of CWC when they pay for services before the Company pays expenses it incurred to provide that service. A positive CWC means that the shareholders have provided the CWC and a negative CWC means that the ratepayers have provided the CWC.

Prior rate case studies have consistently shown that customers provide more cash for Aquila's day-to-day operational needs than external sources. These results are consistent with Aquila's working capital model results (before adjustment) that showed negative working capital needs for Missouri.

Q. Is cash working capital the same as working capital?

A. Cash working capital is a component of working capital. Working capital, while it includes cash working capital, also includes materials and supplies, inventories, fuel stock inventories and prepayments.

Q. Did Staff perform a cash working capital analysis in this case?

A. While Staff did not perform a comprehensive lead/lag study, it did review several components of the cash working capital analysis and computed the expense lags for purchased power, gas supply and coal inventories. These expense items were examined because they formed some of the basis for Aquila's analysis. That analysis found that these items did not create a working capital need for the Company. We found that the outflow of cash to pay for the expense items was matched with the inflow of revenue so no lags resulted and positive and negative cash flows were balanced.

Q. How did Staff calculate the lag associated with purchased gas and purchased power?

A. The Staff compared the delivery dates with the dates the invoices were paid. These calculations resulted in a purchased gas lag for electric generation of 37.6 days, a purchased power lag of 45.3 days and a purchased gas for gas distribution lag of 39.2 days.

The coal lags were used from the previous case, Case No. ER-2001-672. Those lags are 25 days for the Sibley Generating Station and 7 days for the Jeffrey Generating Station and were calculated in the same manner. It should be noted that the Sibley lag created a requirement, but when netted against the purchased gas, purchased power and the other coal lag created a net positive cash inflow or a negative cash working capital requirement.

Q. How did the Staff determine that these components created no cash working capital requirement?

A. The Staff compared the cash receipts (revenue lag), as it is defined in the cash working capital analysis, with the expense lags. The cash receipts lag (when the Company receives revenues from its electric and natural gas customers) was calculated in Aquila's last rate case, Case No. ER-2001-672. The revenue lag in that case was 21.6 days [Source: Accounting Schedule 8]. When the receipts are compared with disbursements, it is obvious that the cash available to the Company exceeds the cash disbursements requirement associated with these expenses.

Q. Is the working capital that is included in the ratemaking process the same as the working capital that the Company is referencing for the Term Loan?

A. No. Working capital used to determine rates is based upon normalized operations and calculated on an annual basis. The working capital that the Company is using to support its Term Loan agreement, as noted above, is on a worse case scenario. It is calculated based on the winter peaking months only. This was done to support a substantial working capital need of the regulated utilities in order to create the perception of a need for the regulated operations to pledge their assets to fulfill the Term Loan's post-closing requirement.

Q. Are the Staff's CWC results comparable with the Company's working capital model that it presented in this case?

A. Yes. It is noteworthy that while the Company and Staff define working capital requirements differently and the approach to the analysis is different, the results are comparable. The Staff's working capital analysis was determined by netting its negative CWC lead/lag results with the materials and supplies inventories, fuel stock inventories and prepayments, the result of which is a negative $3.7 million. The Company's working capital model resulted in a negative ** ____ ** million for Missouri.

Q. Is Aquila's asset pledging proposal fair to Missouri ratepayers?

A. No. Missouri is being asked to pledge all of its regulated utility assets while it has little if any need for the working capital. In Iowa, on the other hand, Aquila's operations have approximately ** ___ ** of the assets but ** ____ ** of the working capital needs based on its working capital needs estimate for January 2004. Correspondingly, Missouri has less than 6% of the gas load in January 2004. Therefore, Iowa has over twice the working capital requirements of Missouri at the time of the Company's working capital peak. While Iowa is also being asked to pledge 100% of their regulated assets, even if approved, Iowa would still be pledging assets worth substantially less than Missouri's assets. [Source: July 17, 2003 Interview Tr., pp. 645 – 647]

SECTION 4: WORKING CAPITAL NEEDS ARE EXAGGERATED BY AQUILA'S INTERNAL MONEY TRANSFER PROGRAM

Q. What is Aquila's policy for handling cash receipts?

A. All customer payments are deposited into a lock box at the Company's primary banking facility. The revenues are then posted to Aquila's books as credits to

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divisional Accounts Receivable and debits to Cash. The Cash is transferred to Aquila's Treasury Department by posting a credit to Cash and a debit to To/From Corporate account on the Divisions' records, and a debit to Cash and credit to the To/From Division account at the Treasury Department level.

Q. How are payments posted for goods and services made by the operating division?

A. Payments for goods or services are disbursed by the Treasury Department. Such disbursements are posted as a credit to the To/From Corporate account and a debit to the appropriate expense account at the division level, and as a debit to the To/From Division account and a credit to Cash at the Treasury Department level. Other disbursement transactions are processed in a similar manner.

Q. Since all the monies are swept into the Corporate Treasury Department accounts does that mean that the monies technically belonging to a division with a positive cash flow could be used by other operating divisions?

A. Yes. If an operating division is a positive cash flow provider, then the excess funds provided by that entity could be used on an as-needed basis by other operating divisions, both regulated and non-regulated.

Q. Does an operating division that is a positive cash flow provider receive any "interest" on the excess funds from Aquila's?

A. Yes. According to responses made by Ms. Beth Armstrong, Chief Financial Officer of U.S. Networks, during the July 17, 2003 interview, the Company posts interest income to the operating division whenever that division is in a positive cash flow position at the Treasury Department level. [Source: July 17, 2003 Interview Tr., p. 534, line 22 through p. 535, line 4]

Q. Does an operating division that has a negative cash flow position at the Treasury Department level pay interest on the funds that have been advanced?

A. Yes. If an operating division is in a negative cash flow position, that division is charged interest for any funds advanced by the Treasury Department. [Source: July 17, 2003 Interview Tr., p. 534, line 22 through p. 535, line 4]

Q. Do the interest rates charged and paid by the Treasury Department represent a reasonable return on investment for both the Treasury Department and the operating division when monies are either borrowed from the Treasury Department or loaned to the Treasury Department group by the operating division?

A. Yes. The Treasury Department pays the same amount whether borrowing monies or loaning monies to the operating divisions.

Q. Please define the phrase "internal dividends" for purposes of this testimony.

A. Aquila is set up as a corporation with operating divisions rather than as a parent company with subsidiaries. In a situation where the corporate structure is a parent company and subsidiaries, the subsidiaries operate as separate entities and as such establish a dividend plan based on each entity's financial status, cash flow needs and net income. Companies set up as corporations with operating divisions normally report on a total company basis. In a situation where financial information must be accounted for on a division-by-division basis, such as when the division is a regulated utility for purposes of setting rates, it becomes imperative that all financial transactions be maintained on a division-by-division basis. In order for the corporation to receive/transfer monies earned at the division level, "internal dividends" are created. "Internal dividends" are defined for purposes of this testimony as monies earned at the division level that are transferred from the division to the corporate level on a permanent basis.

Q. How does Aquila accomplish these permanent cash transfers or "internal dividends" from the operating levels to corporate?

A. According to the Company, in each quarter 70% of one-fourth of the divisions' budgeted annual income is permanently transferred to corporate as an internal dividend. Since November 13, 2002, when the Company ceased paying dividends to its shareholders through June 30, 2003, the Company has permanently transferred $40.434 million from out of its utility cash balances. [Source: July 17, 2003 Interview Tr., p. 538, ll. 4-22]

Q. Why does the Staff believe that the transfer of funds through the "internal dividend" process is, during the current financial crisis, detrimental to the public interest?

A. The Staff believes that "internal dividends" issued to the Aquila Treasury Department during this current financial crisis creates an artificial need for increased working capital that would not otherwise exist and are, therefore, detrimental to the public interest. Aquila is using this artificial need for increased working capital to justify pledging utility assets to support the transfer of utility monies to pay non-regulated expenditures. If the monies were maintained in the division's To/From Corporate/Division accounts, then the individual divisions would have more cash at their disposal interest free or potentially even earning interest. In other words, if the monies were available internally, the division would not need to borrow as much, and potentially, not any additional funds for working capital purposes. The fact that the monies are transferred on a permanent basis to the Treasury

Department allows the Company to use the funds earned through the profitable operating divisions to pay the expenditures of its non-regulated operations and otherwise subsidize the operations of those divisions. The Staff believes it is unfair to cause the ratepayers to subsidize these non-regulated entities by unnecessarily increasing the working capital needs of the utility and subsequently increasing the costs to the ratepayers.

Q. Has the Company declared a moratorium on dividends to shareholders during this current financial crisis?

A. Yes. The Company has ceased paying dividends to shareholders as a means of conserving resources in an effort to reduce debt and other obligations and regain an investment grade rating.

Q. Is the Staff able to draw a parallel between the Company's two dividend policies?

A. Yes. The Staff believes that if the Company chooses not to pay external dividends to its shareholders during this financial crisis, then the Company should not pay "internal dividends." Not only should the monies be maintained at the division level to reduce the working capital needs of the division and, thereby, lessen the costs to the ratepayers, but also the monies earned as a result of regulatory operations should not be used to subsidize the non-regulated operations.

SECTION 5: STATUS OF THE TERM LOAN COLLATERAL PROCESS

Q. Did the Company discuss pledging domestic utility assets as collateral for the Term Loan as part of its Application and direct testimony?

A. Yes. The Company is proposing that all regulated assets of the domestic utilities be pledged as collateral for the Term Loan. The Company is not proposing to limit pledging utility assets to only the amount it alleges it needs to fund utility working capital needs. Aquila is seeking to pledge utility assets to support the non-regulated amount of the loan as well. [Source: Aquila Application, filed April 30, 2003, p. 7]

Q. What is the current status of the regulated utility properties pledged toward the Term Loan?

A. Currently, the regulated assets of the states of Nebraska, Michigan and Colorado are pledged as collateral to this Term Loan.

Q. How are the assets valued for purposes of debt capacity?

A. The valuation of the Company's assets is provided on Schedule RD-2 of the direct testimony of Company witness Dobson. The value of these assets, for purposes of determining their collateral value (debt capacity value), is accomplished by taking the value of the assets, reducing that value for any outstanding debt and then multiplying that amount by the loan value factor. Those loan factor values were set at 50% for the initial collateral, which included the Canadian properties, Michigan-regulated utility properties and Nebraska-regulated utility properties. The IPPs were valued using the Net Present Value of equity distributions from contracted power plants at discount rates of 10% to 12%.

The Company had each of the assets originally pledged as collateral for this loan appraised by BearingPoint to determine its debt capacity value. Aquila later had the Colorado assets appraised. The value of the original domestic regulated assets and the value of Colorado assets that were added to the collateral pool for purposes of meeting the debt capacity is now ** ______ **million. This means the Company presently has more than adequate collateral to meet the terms of the loan agreement that it alleges supports the $250 million working capital needs related to its regulated utility operations.

Q. How much additional collateral will the Company need to pledge to meet the collateral requirements?

A. In order to meet the terms of the loan facility, the Company will need to pledge additional regulated utility assets valued at ** _____ ** million for debt capacity. If the Company is unable or unwilling to do this by the sale date of the Canadian assets, the loan will need to be paid down to an amount equal to the debt capacity of the assets pledged. It should be noted that any additional utility collateral that is pledged only allows Aquila not to pay down the debt related to its non-regulated operations, which it needs to do.

Q. Does Staff believe that the terms of the loan agreement requiring the Company to pledge regulated utility collateral with a debt capacity of at least $430 million to be detrimental to the public interest?

A. Yes. The pledging of assets with a debt capacity in excess of $250 million is in fact the subsidy of non-regulated operations and, therefore, detrimental to the public interest. Aquila's non-regulated operations are completely responsible for the financial hardship of this company.

Q. Does the Staff believe it is detrimental to the public interest to pledge any of Missouri's assets toward this loan?

A. Yes. As previously stated in this testimony, the loan is already accomplished. No additional funds for working capital were received as a result of the execution of this loan. The loan proceeds were used to pay off the Company's existing line of credit. Over-collateralizing this loan will not provide $1 for use by the Company. In fact, the additional collateral only provides these lenders with more security for their loan, thereby, providing them greater protection in case of default or bankruptcy. Aquila's utility operations have had access to the capital markets to meet its working capital needs, short-term and long-term obligations. It is only the Company's poor financial conditions that caused Aquila to maintain an excessive cash balance to support its working capital commitments because traditional methods are no longer available to the Company.

SECTION 6: COST OF LINES OF CREDIT ALREADY INCLUDED IN COST OF SERVICE

Q. Does the Company's current cost of service include the cost of providing working capital through a revolving line of credit?

A. Yes. The Staff included the cost associated with the traditional line of credit financing for the Company's working capital needs in its cost of service calculations during the last rate case, Case No. ER-2001-672. As previously indicated, lines of credit are by far the more efficient and effective way to meet the short-term obligations, such as the working capital needs of the Company. Most major companies of which we are aware have established lines of credit with their financial institutions so they can access cash as needed. This is the practice that Aquila and its predecessor, UtiliCorp, operated under prior to this financial crisis. Because of the Company's poor liquidity, financial institutions were no longer willing to provide a revolving line of credit to meet the Company's obligations, which resulted in the need for the Term Loan agreement. The Company's poor financial condition is the sole reason why it has had to resort to obligating the Company for a loan to meet the working capital needs for its businesses.

Q. Does Staff believe Missouri's regulated assets should be used to support the Company's poor financial conditions that resulted from its non-regulated operations?

A. No.

SECTION 7: APPLICATION REFLECTS THE FINANCIAL CONDITION OF AQUILA-NOT THE ONGOING REGULATED MISSOURI OPERATIONS

Q. Does this Application reflect the financial condition of Aquila's regulated Missouri operations?

A. No. Missouri's regulated operations are financially sound. If the Missouri utilities were operating on a standalone basis, there would be no need to pledge Missouri assets to obtain a loan to support the working capital needs of the Company. Missouri's utility operations would qualify for traditional financing, such as a line of credit and, as such, would be able to develop their own cash management and dividend policies. Even if it was part of a financially healthy parent/subsidiary relationship, it would be likely that the earnings of the Missouri operations could be retained to finance their short-term construction and working capital needs. A distressed parent puts pressure on the companies/divisions that generate cash to transfer that cash to the parent/Treasury Department. Once that cash is transferred, it puts more of a burden on the profitable operations to externally finance working capital requirements and construction projects.

Q. Does the Application reflect the financial conditions of Aquila as a whole?

A. Yes. This Application is driven by the weakened financial condition of Aquila, which is solely the result of the losses sustained by its non-regulated operations.

Q. How does the detriment to the public interest standard apply to this argument?

A. If the need to file this Application is driven by the weakened financial conditions of the non-utility divisions of the Company, then it is easy to draw the parallel that assets of the utility divisions should not be encumbered to support this loan and that these assets must be protected for the benefit of the utility ratepayers in case of future financing needs.

STATUS OF FINANCING CASES IN OTHER JURISDICTIONS

Q. With respect to the similar applications filed in Kansas, Iowa, Colorado and Minnesota, please provide an update on these cases.

A. The Kansas Corporation Commission has established a procedural schedule for that state's financing case. Kansas Staff are currently in the discovery phase and is scheduled to prefile direct testimony October 31, 2003. Aquila is to prefile rebuttal testimony on November 14, 2003. Kansas' hearings are scheduled to occur on November 20-21, 2003.

In Iowa, the Company's Application is being contested. The testimony was prefiled in the case. The Iowa Utility Board heard the case on August 26, 2003, and is to issue its order by October 29, 2003.

The Colorado Commission Staff and Aquila reached an agreement to allow the Company to pledge that state's assets toward the three-year Term Loan. Staff received a copy of the Administrative Law Judge's recommendation to approve the Colorado Stipulation. This recommendation contained a provision that indicated if no disagreement to the Stipulation was noted, the Stipulation would go into effect after 10 days as though the Commission issued an order approving said Stipulation. No objections were received and the agreement became effective July 10, 2003.

The Minnesota case is being contested. Parties to the case are presently in process of filing comments before the Minnesota Public Utilities Commission. This case is being handled on an informal basis. No hearing date has been set.

Q. Does this conclude your revised rebuttal testimony?

A. Yes it does.