STATE OF MINNESOTA
BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

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| LeRoy Koppendrayer | Chair |
| Marshall Johnson | Commissioner |
| Phyllis Reha | Commissioner |
| Gregory Scott | Commissioner |

In the Matter of a Request by Aquila, Inc. for Authority to Use Aquila Networks-PNG and Aquila Networks-NMU Utility Property To Secure Indebtedness

MPUC Docket No.: G007,011/S-03-681

## AQUILA, INC. REPLY COMMENTS

These Reply Comments are submitted by Aquila, Inc. and its Divisions Aquila Networks-PNG and Aquila Networks-NMU ("Aquila"), in response to the Minnesota Department of Commerce ("Department") and Office of Attorney General ("OAG") August 19, 2003 Comments concerning Aquila's request to encumber its Minnesota utility property to secure the payment of $250 million of a $430 million loan and to secure future replacement debt offerings for working capital requirements. The Department recommends that the Minnesota Public Utilities Commission ("Commission") deny Aquila's request because Aquila cannot, without incurring significant and otherwise avoidable penalties, buy down the Term Loan as fast as the Department would prefer. The Department's recommendation is premised on the mistaken belief that it would be in the best interest of the ratepayers and the Company to use the proceeds from the sale of non-utility assets to eliminate as much of the Term Loan as quickly as possible. The OAG's recommendation is premised on the mistaken belief that Minn. Stat. § 216B.49 requires utility operations to be funded by stand-alone debt. There is nothing in Section 216B.49 supporting such a conclusion, and the argument ignores the reality of how a utility that is not owned by a holding company must operate.

Further, approving Aquila's application does not increase the risk of bankruptcy and, therefore, does not increase the risk to ratepayers. But denying Aquila the capital it needs as part of its overall financial plan to regain the status of an investment grade utility is harmful to the public interest. Therefore, the Commission should approve Aquila's request as a good faith effort to resolve its financial problems with no additional risk, or cost to the ratepayers.

As will be described in more detail in subsequent sections of this response, the recommendations of the Department and OAG are detrimental to the financial position of Aquila for the following reasons:

1. Aquila would be required to retire lower-cost debt and not maximize the benefit of its asset sale proceeds.
2. Aquila would have less cash available to repay the 2004 debentures when they become due if it is required to use the asset sale proceeds to retire the term loan, potentially leading to a liquidity crisis.
3. Aquila's financial plan enables the customers to receive a lower cost long-term debt rate by guaranteeing them an investment-grade utility rate. Changing this plan to meet the Department's mandatory prepayment requirement, on the other hand, jeopardizes Aquila's financial well-being without providing any benefit to customers.

## A. Artificially Accelerating Repayment Of The Term Loan Would Not Be In The Public Interest.

Aquila is in the process of selling all of its remaining unregulated assets. Because of the need to time these sales to maximize their value, at least some of the assets are expected to remain on Aquila's books for one to two years. The Department recommends rejecting Aquila's Application because the Company would not be able to buy down the Term Loan as quickly as the Department prefers. The Department's preference, however, is based on the faulty premise that retaining more than the minimum amount of the Term Loan would not be in the ratepayer's or Company's best interest. In fact, the Company needs the flexibility to retain the maximum amount of the $180 million Term Loan supportable by nonregulated asset collateral.

During discussions with the Department, the Department requested that Aquila accelerate, to the maximum extent possible, the buy down of the nonregulated portion of the debt (the $180 million supported by nonregulated assets). Aquila's representatives agreed to take that request back to the people responsible for managing Aquila's financial plan to determine whether such a request was both feasible and in the overall best interest of Aquila's financial needs. As explained in Aquila's August 1, 2003 letter to the Department, which is appended to the OAG's comments, the forced early retirement of the Term Loan would be harmful to Aquila's financial position.

Aquila's present primary financial goal is to become an investment grade utility. Becoming an investment grade utility is in the public interest because utilities need access to large amounts of capital to assure safe, reliable and affordable service. While Aquila can meet those needs in the short run without being an investment-grade utility, it would, over time, become increasingly more difficult and expensive.

The Department incorrectly assumes that the Company can further that goal with the early retirement of the Term Loan. It cannot. The Department assumes that even at 8.0% (the reduced rate available to Aquila if the Term Loan is secured by adequate utility assets) the loan is a high cost loan for Aquila. It is not.

Aquila has $500 million of 14.875% debt; $250 million of 9.95% debt; $20.2 million of 9.03% debt; $5.0 million of 9.0% debt, and another $120 million of debt at 8.2%. Using the proceeds from the sale of the nonregulated assets to buy down debt improves the Company's financial position over the forced retirement of the Term Loan. Aquila needs the flexibility to make the most cost effective decision in order to achieve financial stability.

Even more pressing is the fact that the Term Loan requires Aquila to redeem at least 80% of the July 2004, $150 million and October 2004, $250 million bonds prior to their respective maturities, or the entire Term Loan of $430 million becomes due. If Aquila uses the proceeds from the nonregulated and international asset sales to prematurely retire the $180 million portion of the Term Loan, and therefore does not have sufficient cash to retire the 2004 debt maturities, Aquila will be forced into a loan default and potential bankruptcy. Therefore, it is preferable for Aquila to use the proceeds from the sale of its nonregulated assets to repay those bonds rather than repay the Term Loan which does not mature until April, 2006. If the proceeds of the nonregulated assets are diverted to repay the Term Loan rather than the maturing bonds, the risk that Aquila could be forced into default of the Term Loan and bankruptcy increases.

Retiring the 2004 bond series, which are at 7% and 6.875%, would also benefit the ratepayers. That debt has been assigned to domestic utilities, including Aquila Networks-PNG and Aquila Networks-NMU. If Aquila is able to retire that debt, Aquila will need to assign replacement debt to the utility operations to maintain the proper debt/equity ratio. Aquila would most likely assign existing debt on its balance sheet to the utilities for that purpose, and, pursuant to Aquila's commitment, all debt assigned to a utility operation would be assigned at the then current BBB investment rate. Based upon current information available to Aquila, the interest rate for BBB rated long-term debt is 5.95% for 10-year bonds. Consequently, the weighted average cost of debt to the utility operations would be reduced. The difference between the actual cost of the debt on Aquila's balance sheet and the assigned BBB investment rate would be borne by Aquila and not the ratepayers.

In addition, the Department's earlier June 30th Comments acknowledge that if the State Commissions allow enough utility property to be used to secure the Term Loan Facility, a 75 basis point reduction in the interest rate would occur (decreasing interest expense by $3.2 million a year). The Department provides no justification for potentially foregoing that significant cost saving.

The "Recommended Decision of Administrative Law Judge Dale E. Isley approving Stipulation and Settlement Agreement" for the State of Colorado, at paragraph 16, makes the following finding concerning the relationship of the debt issuance and the goal of becoming an investment grade utility:

> The parties believe that granting the application, subject to the terms of the Stipulation, is in the public interest. Having reviewed the Stipulation, the application, the prefiled testimony and exhibits submitted by Aquila in this matter, and the testimony presented by the parties at the hearing, the undersigned agrees. **Subject to the conditions contained in the Stipulation, approval of the pledge of Aquila's Colorado utility assets to secure the loan will greatly assist Aquila's efforts to implement the Financial Plan and, ultimately, should serve to return it to a capital structure reflective of a gas and electric utility and to restore its debt rating to investment grade.**

(Emphasis added.) The Colorado Administrative Law Judges' ("ALJ") recommended decision approving the encumbrance application became final on July 10, 2003, and a copy was attached to Aquila's July 15th Comments in this Docket. Jon Empson's Supplemental Direct Testimony included a copy of the referenced Stipulation. As stated on page 4, line 3, of that Testimony, Aquila accepts the conditions outlined in the Colorado Stipulation for application in Minnesota.

Aquila acknowledges the Department's intent to protect the overall ratepayer interests. However, this is an area where the financial pieces are too complex and fluid to be managed under unnecessary restrictions. Aquila is doing everything it can to overcome its financial problems, and needs the flexibility it has requested to return to being an investment grade utility.

### B. It Is Neither Possible Nor Necessary To Compartmentalize The Term Loan As The OAG Prefers.

The OAG asserts that "a legal firewall between the loan provisions concerning regulated and unregulated obligations must be erected." It is erroneously suggested that Minn. Stat. § 216B.49 may require such a result. Further, contrary to the OAG's assertion, Aquila's Application is not inconsistent with its statements to the Commission in Aquila's last rate case.

Aquila is not a holding company, and its operating divisions are legally indistinguishable from Aquila, Inc. As such, the utility operations cannot issue stand-alone debt. Despite that legal necessity, Aquila has assured that the cost of providing utility service is determined as if Aquila had only utility operations. Consequently, in its last rate case, Aquila and the Department agreed that a separate <u>assigned</u> divisional capital structure, rather than Aquila's consolidated capital structure, should be used to determine the Aquila Networks-PNG and Aquila Networks-NMU revenue requirements.

Aquila and the Commission reinforced the use of an appropriate <u>assigned</u> divisional debt, rather than Aquila's consolidated capital structure, for determining the cost of debt in its next rate case, as memorialized in the Commission's February 14, 2003 ORDER APPROVING JOINT RECOMMENDATION, *In the Matter of an Inquiry into Possible Effects of the Financial Difficulties at Aquila, Inc. on Peoples Natural Gas Company and Northern Minnesota Utilities Company,* Docket No. G-007,011/CI-02-1369, requiring Aquila to:

(a) identify all issuances of debt and associated costs from January 1, 2002, until the next rate case in a manner that will facilitate a potential adjustment to mitigate the impact of adverse market factors caused by

Aquila's financial problems. Specifically, Aquila shall provide information sufficient to allow the Commission to evaluate what the debt and equity costs for Peoples and NMU would have been but for the effect of Aquila's other operations; and

(b) provide a discussion and analysis of the effects of Aquila's financial situation on Peoples' and NMU's cost of common equity.

Clearly, Aquila has never asserted that it would not have consolidated debt or that its utility operations would issue stand-alone debt. Rather, Aquila has consistently acted to ensure that the cost of the debt allocated to its utility operations reflects the cost of debt appropriate to an investment grade utility. Aquila continues to support such a result, and its promise to use the cost of debt for an investment grade utility for any new debt assigned to a utility is fully consistent with Aquila's past practices and promises of future behavior to the Commission.

Nor does Minn. Stat. § 216B.49 require that utility debt be stand-alone debt. The OAG notes that the statute requires a "public utility" to obtain Commission approval before issuing debt. More specifically, Section 216B.49, subd. 3, provides simply:

> It shall be unlawful for **<u>any public utility</u>** organized under the laws of this state **<u>to sell any security</u>** or, if organized under the laws of another state or foreign country, to subject property in this state to an encumbrance for the purpose of securing the payment of any indebtedness **<u>unless the security issuance of the public utility</u>** first be approved by the commission.

(Emphasis added.) Under the OAG's interpretation of this provision, utilities would need to issue stand-alone utility debt. As such, all utility companies would either be required to engage exclusively in regulated operations or they would be required to adopt a holding company organizational structure. Under the OAG interpretation, a Minnesota domiciled non-holding company, like Aquila, Inc., which is the same legal entity as Aquila Networks-PNG and Aquila Networks-NMU, could not issue **<u>any debt</u>** for non-utility purposes. Clearly that is neither contemplated nor required. If it were, it would be expressly stated, and would most likely be preempted by the Public Utility Holding Company Act of 1935 ("PUHCA")[1].

While the OAG seems to contemplate an agreement with the lenders that would compartmentalize Aquila, Inc. into regulated and unregulated enterprises, it is highly doubtful that such distinctions would have any effect in the event of a default and bankruptcy. Further, the protection the OAG seeks is unnecessary. The Department states (page 10) in its earlier June 30th Comments: "In sum, the risk for the ratepayers does not appear to be any greater with encumbrance than without encumbrance in bankruptcy." In fact, issuance of debt needed for operational needs at a reasonable cost decreases, rather than increases, the risk of bankruptcy or default.

Finally, the OAG ignores that the issuance of consolidated debt was necessary to obtain the funds Aquila needed for its utility cash working capital needs. Aquila needed to replace $650 million of revolving credit agreements and other maturing obligations that became due on April 12, 2003 or it would go into default and likely bankruptcy. To do so, Aquila needed to issue new debt, and to obtain that debt, Aquila needed to secure the debt. $250 million of the new debt was needed to meet the cash working capital needs of Aquila's utility operations. Aquila could not provide adequate security for the $250 million needed for its utility operations using only utility property by April 12th because of the need to obtain regulatory approvals. Therefore, Aquila was forced to issue consolidated debt, initially using primarily nonregulated assets to secure the debt needed by its utility operations. Under the OAG's interpretation of Section 216B.49, a Minnesota domiciled utility could not have issued the consolidated debt at all, and a utility organized in another state, like Aquila, could not secure the portion of the

[1] PUHCA, 15 U.S.C. § 79 et. al. closely regulates and limits the use of a holding company structure in conjunction with public utility operations.

consolidated debt needed for utility operational purposes. Such an interpretation of the statute is unreasonable. Aquila's utility operations are benefiting from the Term Loan and should provide the security needed to support the Term Loan.

In summary, the Company is moving with all reasonable speed to sell all of its unregulated assets. When those assets are sold, the Term Loan will be reduced to the $250 million needed for utility operations.

In its July 15, 2003 Reply Comments, Aquila made the following commitment:

> The amount of Term Loan Facility secured for utility operations will not exceed $250 million (unless a subsequent Aquila request is approved by the Commission authorizing an increase in utility working capital (e.g. because gas costs have increased). To the extent that the Term Loan Facility is used for both utility and non-utility operations, the amount of debt used for non-utility operations will be secured by sufficient non-utility assets (at a ratio of at least 1.67 to 1). The amount of the non-utility debt will be reduced as necessary to meet this commitment.

Therefore, the Company has done all that it can under these circumstances to match the use of security to the purpose of the debt. To adopt the OAG interpretation of Section 216B.49, subd. 3, would essentially deny all but stand-alone utilities access to debt. Such an interpretation is contrary to the operating needs of utilities and contrary to the public interest.

**C. Conclusion.**

The request to encumber Minnesota regulated assets should be approved by the Commission:

- It is in the public interest.
- Ratepayers will not assume responsibility for debts incurred to support nonregulated businesses.

The amount of Term Loan Facility secured for utility operations will not exceed $250 million (unless a subsequent Aquila request is approved by the Commission authorizing an increase in utility working capital, e.g. because gas costs have increased). To the extent the Term Loan Facility is used for both utility and non-utility operations, the amount of debt used for non-utility operations will be secured by sufficient non-utility assets (at a ratio of at least 1.67 to 1). The amount of the non-utility debt will be reduced as necessary to meet this commitment.

Dated: August 29, 2003

Respectfully submitted,

By ______________________________
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