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POWER POINTS: Back-To-Basics May Not Pay Aquila's Bills

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NEW YORK -- Maybe one reason you can't go back to the farm after having been to Paris is that you can't pay off your Chanel and Gaultier bills on a farmer's income.

That may be the lesson learned by Aquila Inc. (ILA), which is trying to return to its roots as a basic power and natural gas regulated utility in the Midwest.

The income from that line of business may not cover the cost of servicing leftover debt from almost $2 billion in poor investments in telecom, merchant energy and a British utility. Regulators aren't going to let customers of Aquila's monopoly gas business back in Missouri, for example, pay for the company's unused merchant power plants.

So the company's future depends on its ability to sell assets at good prices to pay off debt and reduce interest costs as much as possible. Some analysts don't think it will work.

"I don't see them digging out of the hole," said Bank of America Securities' debt analyst Craig Gilbert. "In our view they aren't going to generate enough free cash flow in the future to materially reduce debt, but the value of the assets should come close to the liabilities."

Aquila executives admit that the road ahead is rough.

"At this point, with our stock in the $2 range, we're like an option premium on how the divestitures come out," Aquila Chief Financial Officer Rick Dobson said in an interview.

Even after the company finishes selling noncore assets and negotiating discounts on some obligations, it still will have some debt left over from its failed investments.

"That leaves an overhang on our books," said Dobson. "Whether that's $100 million or $500 million, almost all debt holders are doing the math, and coming to their own conclusions."

Tough Numbers

For investors, the math isn't that complicated. Once the company sheds assets and gets through numerous requests for gas and electric rate increases, it projects a slightly optimistic earnings before interest and taxes from its utilities of about $250 million a year, up from about $180 million from its utilities currently.

Taxes will likely be negligible, but its current annual interest expense is about $260 million. State utility regulators won't force trapped power and gas customers to pay for the higher interest rates that resulted from credit downgrades due to its nonutility ventures.

For debt allocated among Aquila's various local utilities, customers reimburse Aquila at interest rates of 7% to 8%, as if the company were still investment grade. In fact, Standard & Poors rates it single-B, five steps below investment grade. The highest interest rate it pays - on a recent $500-million bond issue - is a whopping 14 7/8%.

Aside from interest expense, Aquila for years to come has to spend more than $130 million annually buying natural gas for other utilities that have already paid Aquila. The company is also paying $37 million a year through 2015 for the right to generate power at a big merchant power plant in Illinois that can't make money in the current market. A similar long-term deal will start costing $21 million in 2006.

If interest costs aren't reduced, that would add up to a cash burn rate of almost $200 million a year, so the key is to sell assets and pay off debt. Big bondholders - conservative types by definition - usually discount management's utility earnings projections and start with higher current interest expense.

Clarity To Come

The critical element in Aquila's cash picture is what prices it gets for its Canadian utilities and its profitable independent power plants, known as "qualifying facilities," which have contracts to sell power to other U.S. utilities. The company has received indicative bids, but it won't share numbers until it has agreements in hand later this year.

"By the time we report third-quarter earnings, a lot of the mystery should be solved," said Dobson, who added that Aquila's big rate cases won't be resolved until next spring.

Gilbert estimated that after fees and taxes Aquila may get about $600 million for its Canadian utilities and $200 million to $250 million for its qualifying facilities. Gilbert, who also trades Aquila debt, thinks those sales will keep Aquila going for a couple of years, so he has a "buy" rating on the company's near-term debt. But he doesn't see how the company can become cash-flow positive any time soon.

Most Wall Street estimates on what Aquila will get for the assets, Dobson said, are at the low end of the company's expectations. In any event, Aquila can't use all of the proceeds to pay down debt, he said. It needs to retain some cash to get through the current negative cash flow period, though it will certainly pay off $400 million in bonds due next year.

As of June 30, the company had a little more than $500 million cash on hand. For the first half of the year, its continuing operations lost $159 million.

What Isn't For Sale

The company has already sold its Australian utility, and the potential sale of its British utility is basically a wash from a debt perspective.

Aquila's three new merchant power plants in Illinois and Mississippi aren't for sale, because they wouldn't fetch much in those oversupplied markets; they aren't even running in the summer.

On the plus side, as the company winds down its trading operation, it will get back collateral it has deposited with counterparties.

Aquila is also negotiating to reduce its obligations on the prepaid gas supplies and its purchased-capacity contracts. Moreover, Aquila is asking several state utility commissions to allow it to pledge utility assets as collateral to contain interest rates.

One other potential help: If U.S. wholesale electricity prices rebound in a couple of years, Aquila's remaining merchant generating stations in Illinois and Mississippi could finally start generating income.

The company's own estimate, however, is that the plants won't start earning meaningful income until 2006 at the earliest.

At the end of the day, said Ellen Lapson, debt analyst with Fitch Ratings, Aquila may be a highly leveraged business relative to its utility income.

"That doesn't mean that it's out of business," Lapson said. "There have been examples, like Tucson Electric Power and El Paso Electric, of highly leveraged utilities that have managed it very gradually over time."

If the company can't pay off extraneous debt from its utility profits, its board of directors could issue new stock or pursue a merger with a bigger company, Dobson said. At the current price, any new stock issue would have to be quite large to make a difference, he added.

Bank of America's Gilbert has a "neutral" rating on Aquila's debt that matures after 2006.

"I see them hanging around for a while," he said, "but eventually they may need to restructure."

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