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IOWA UTILITIES BOARD

OFFICE OF CONSUMER ADVOCATE

**PREPARED DIRECT
TESTIMONY**

and

EXHIBIT

OF

GREGORY VITALE

**IN RE: Aquila, Inc.
Docket No. SPU-03-7**

June 2, 2003

Schedule TJR-29.1

1 Q: What is your name and business address?

2 A: My name is Gregory Vitale. My business address is 310 Maple Street, Des
3 Moines, Iowa 50319-0063.

4 Q: By whom are you employed? —

5 A: I am employed by the Iowa Department of Justice, Consumer Advocate
6 Division (OCA) as a Utility Specialist.

7 Q: What is your educational background?

8 A: I graduated with a Master of Arts degree in Economics from Washington
9 State University in 1984. I graduated from Kent State University with a
10 Bachelor of Arts degree in Economics in 1982.

11 Q: What is your professional experience?

12 A: I was hired as a Senior Utility Analyst by the Iowa Utilities Board in August
13 1985. I transferred to OCA in July 1989. I was promoted to Utility Specialist
14 in March 1990. Since 1985, I have filed testimony in more than forty cases. I
15 have also been involved in other dockets and filings.

16 In 1989, I taught Managerial Finance for Simpson College. I also
17 taught several economics classes at Hiram College in 1984 and 1985. I
18 worked as a teaching assistant at Washington State University from 1982
19 through 1984.

1 Q: Have you prepared an exhibit?

2 A: Yes, Exhibit ____ (GV-1) was prepared by me or under my supervision and
3 contains Schedules A through E. Additional supporting articles, analyses, and
4 other information that I relied upon are included in my work papers.

5 Q: What is the purpose of your testimony?

6 A: The purpose of my testimony is to explain why Aquila's proposal to pledge
7 its Iowa gas utility properties as collateral for this loan is unreasonable, harms
8 its Iowa utility customers and is not in the public interest. I also comment on
9 the testimony, exhibits, and work papers presented by Company witnesses
10 Mr. Jon Empson and Mr. Rick Dobson.

11 Q: How large is Aquila's utility operation in Iowa?

12 A: Aquila provides 142,000 customers gas distribution and transportation service
13 in Iowa. Aquila's Iowa utility rate base is \$66 million. Aquila's Iowa utility
14 revenues are about \$167 million annually. As collateral, Aquila's Iowa utility
15 operations supports the least amount of borrowing capacity of all of its other
16 domestic utility operations. This is depicted on Mr. Dobson's
17 Exhibit ____ (RD-2).

18 Q: Why does Aquila want to pledge its Iowa utility operations as collateral?

19 A: Aquila, in order to gain a waiver of its previous debt agreement violations,
20 had to agree to several conditions. As one of the conditions, Aquila agreed to
21 make a reasonable effort to gain state regulatory approval to secure the three-
22 year loan with additional utility assets.

1 Q: What other conditions did Aquila agree to in order to secure this loan?

2 A: This loan agreement, which is included as Schedule A, [REDACTED]

3 [REDACTED]

4 [REDACTED]

5 [REDACTED], Iowa utility ratepayers may be
6 forced to remain with a financially weakened Aquila even if this were not in
7 their best interests.

8 Q: Why did Aquila agree to these restrictions in the three-year loan?

9 A: Aquila was forced by its lenders to agree to the restrictive terms of this three-
10 year loan in order to avoid bankruptcy.

11 Q: Will Iowa utility assets be pledged as collateral for more than three-
12 years?

13 A: Yes. It is Aquila's intent to continue pledging its utility assets as collateral
14 after this three year loan matures.

15 Q: Will pledging Iowa utility assets solve Aquila's financial challenges?

16 A: No. Aquila's proposal would, at best, leave a financially weak owner of its
17 Iowa utility operations for several more years. Aquila's proposal to pledge its
18 Iowa utility assets as collateral also fails to address, let alone solve, the
19 avoidable risks its utility operations have been and will continue to be
20 exposed to as long as Aquila commingles its regulated and unregulated
21 operations and finances.

1 Q: Why would lenders loan Aquila additional capital if it doesn't solve
2 Aquila's financial challenges?

3 A: As the Wall Street Journal article attached as Schedule B notes, banks have
4 extended billions of dollars of credit to merchant energy companies such as
5 Aquila this year in an effort to avoid bankruptcy proceedings. Bankers
6 believe they will recover more of their investments if they keep the energy
7 merchants on life support until markets improve. This is especially true for
8 unsecured creditors who improve their position by requiring collateral as a
9 condition of a new loan. In the interim, the higher interest payments the
10 lenders required to extend credit increases their cash flow.

11 Q: Why does Aquila need to augment its short-term liquidity needs?

12 A: Aquila is now required to post collateral because its was in default of its loan
13 agreements and its bond rating has been downgraded below investment grade.
14 The debt rating downgrades reflect Aquila's unsuccessful expansion into
15 unregulated energy trading, telecommunications and other operations.

16 Company witness Mr. Dobson notes as much, stating:

17 The fallout from the Enron and California crisis was far
18 more devastating to the entire energy sector than
19 originally anticipated. Revelations concerning corporate
20 governance failures created an environment where the
21 energy industry experienced the adverse impacts of
22 credit downgrades, dramatic reductions in stock value,
23 and major efforts to restructure business operations (p.4).

1 Q: Do Aquila's recent declines in its debt rating reflect an increase in the
2 risk of its regulated utilities operations?

3 A: No. Aquila's debt rating downgrades reflect, among other factors unrelated to
4 its utility operations, an undue reliance on debt capital to finance unregulated
5 and riskier businesses such as its former energy trading operations. In
6 general, the debt rating downgrades in the electric and gas utility industry
7 have not been driven by an increase in the risks of regulated electric and gas
8 utility operations. Standard & Poor's noted these facts, stating:

9 The negative credit picture can be traced to weakening
10 financial profiles (largely attributed to debt raised to fund
11 unregulated business ventures or acquisitions) and
12 increasingly constrained access to credit markets as a
13 result of investor skepticism over accounting practices
14 and disclosure. Investment outside the traditional
15 regulated utility business has increased overall business
16 risk.¹

17 Q: Why does Aquila's failed investments in its unregulated operations affect
18 its utility operations?

19 A: Aquila, unlike most utilities that have substantial unregulated operations, is
20 not a holding company with a separate utility subsidiary. Rather, Aquila's
21 utility operations constitute part of its operating divisions. Other unregulated
22 assets are also operating divisions or are commingled with regulated utility
23 operations in their financial reports. Aquila also has unregulated subsidiaries.

1. Standard & Poor's, Ratings Direct: Industry Report Card: U.S. Electric/Gas/Water,
October 4, 2002, p.1.

1 However, even when its unregulated subsidiaries do issue their own securities
2 some are with recourse to Aquila which includes its regulated utility
3 operations.

4 **Q: How does Aquila finance its utility and its other unregulated operations?**

5 **A: Aquila finances many of its operations on an overall basis and then internally**
6 allocates funds to its various regulated and unregulated operations.

7 **Q: Do Aquila's internal allocations insulate regulated utility operations and**
8 **financing from its unregulated investments and financing?**

9 **A: No. Aquila continues to erroneously assert that its internal capital allocation**
10 process insulates its utility divisions from its other activities. This assertion is
11 contradicted by Aquila's financial crisis which is a result of losses in its
12 unregulated operations. Aquila's ongoing credit crisis affects all of its
13 operations, including its regulated utility operation.

14 **Q: Is Aquila's current assurance that its capital allocation will insulate its**
15 **utility operations from its riskier unregulated operations credible?**

16 **A: No. Aquila continues to fail to insulate its utility customers, operations and**
17 finances from its other riskier unregulated operations. As a result, Aquila's
18 utility operations now have a below investment grade debt rating and are
19 incurring excessive costs to secure additional finances Aquila ostensibly
20 claims are needed. Aquila should have taken, but did not, the necessary steps
21 to insulate its regulated utility customers, operations, and finances as other
22 utilities have done, before its expansion into riskier unregulated investments.

1 Q: How have other utilities insulated their utility operations and customers
2 from their riskier unregulated operations?

3 A: Most other companies protect their utility assets, finances and customers
4 through a holding company structure with a separate utility subsidiary. For
5 example, over 90% of the electric utility companies identified by the financial
6 publication Value Line have a holding company structure. The other utilities
7 that are not part of a holding company are smaller and have little, if any,
8 unregulated operations. Aquila is one of the few exceptions to this pattern.
9 Details are summarized on Schedule C.

10 Q: How significant were Aquila's unregulated operations?

11 A: Aquila earned more than 50% of its profits from its unregulated operations in
12 2001 when it had substantial energy trading and merchant operations.

13 Q: Has the Board ever relied on a holding company structure to protect a
14 company's regulated utility from its other unregulated operations?

15 A: Yes. The holding company structure, as the Board previously noted in a
16 MidAmerican proceeding, helps isolate regulated utility operations from
17 liabilities imposed by a company's other unregulated operations.²

18 Q: Can the Board create its own firewall to protect Iowa utility customers
19 from Aquila's higher capital costs and lower bond rating?

2. See page 4 of the Board's Order in SPU-96-9 dated June 11, 1996 regarding MidAmerican Energy Company and MidAmerican Energy Holdings Company.

- 1 A: Yes, but only in part. The Board can protect Iowa utility customers from
2 Aquila's higher capital costs in a rate case. The Board cannot, however,
3 protect Iowa utility customers to the same extent in the event Aquila files
4 bankruptcy due to the losses from its unregulated operations. One of the
5 many risks is that Iowa utility customers could lose more than \$500,000 in
6 deposits and funds if Aquila declares bankruptcy and their claims are treated
7 like other unsecured creditors.
- 8 Q: In the event of a bankruptcy, has Aquila made its utility customers worse
9 off by agreeing to this loan?
- 10 A: Yes. Prior to this new loan, the unsecured lenders' rights to any proceeds in a
11 bankruptcy proceeding would have been after the claims of Aquila's utility
12 customers. But now with this new loan as secured creditors, the lenders'
13 claims would be before Aquila's utility customers.
- 14 Q: Because Iowa utility customers' funds are at risk, does it mean it would
15 be in their interest for Aquila to avoid bankruptcy?
- 16 A: No. Aquila's utility customers are at risk whether Aquila files for bankruptcy
17 or manages to avoid bankruptcy as a financially weakened firm paying off
18 debts from its failed unregulated investments. Aquila's utility customers are
19 at risk as long as its regulated and unregulated finances are commingled as
20 they are now and would continue to be under this new loan.

1 Q: How can Aquila's Iowa regulated utility customers be effectively
2 insulated from Aquila's unregulated operations?

3 A: Iowa's utility operations can be protected as effectively as Portland General's
4 customers. Portland General continues to have an investment grade rating
5 even though Enron, its parent company, has been forced to file bankruptcy
6 due to its unregulated operations. Aquila's ongoing credit crisis is a result of
7 its investments in riskier unregulated but commingled operations. This makes
8 it obvious that the public interest, as well as safe and reliable utility service,
9 requires a standard corporate holding company structure with strict separation
10 of regulated utility assets and finances from unregulated operations.

11 Q: How does Aquila justify pledging its regulated utility operations in Iowa
12 as collateral for this three year loan?

13 A: Aquila claims that it needs this loan for working capital and that it is only fair
14 that all utility assets should be pledged as collateral in order to support the
15 working capital for its overall utility operations.

16 Q: Does Aquila claim that its Iowa gas utility operations need additional
17 working capital?

18 A: No. Aquila only claims that it needs to pledge additional working capital for
19 its overall utility operations.

20 Q: How much is Aquila borrowing under this three-year loan for working
21 capital?

- 1 A: The loan is for a total of \$430 million. Aquila, however, claims that only
2 \$250 million is needed for its overall utility working capital needs. The rest
3 would support Aquila's remaining unregulated assets and liabilities.
- 4 Q: Should Iowa utility assets be pledged as collateral for Aquila's other
5 operations?
- 6 A: No. Iowa utility assets should not be pledged as collateral to support this loan
7 which may be used by Aquila's riskier unregulated operations.
- 8 Q: Doesn't Aquila claim that it would internally keep its regulated and
9 unregulated operations working capital needs separate?
- 10 A: Yes. Aquila does assert it will separate access to the common pool of funds
11 made available by this loan between its regulated and unregulated operations.
12 Aquila's assertion, unfortunately, is unenforceable. It does not reflect the way
13 this loan is structured, the collateral rights of the lenders, the problems and
14 abuses that have arisen from a common pool of funds used to support both
15 regulated and unregulated operations, and the way Aquila has operated in the
16 past.
- 17 Q: Do the financial institutions make the distinction between how the loan is
18 used or secured between regulated and unregulated operations?
- 19 A: No. According to Mr Dobson, the financial institutions only require Aquila to
20 pledge sufficient assets to secure the \$430 million loan.

1 Q: How did Aquila determine that it needed this loan for its utility working
2 capital?

3 A: Aquila claims it needs access to this loan for utility working capital based on
4 a new review of its peak needs and a review of other utilities working capital
5 arrangements.

6 Q: Has the Iowa Utility Board ever relied upon Aquila's techniques to
7 determine working capital needs?

8 A: No. Aquila's request to pledge its Iowa utility assets as encumbered collateral
9 for working capital is based on a unapproved methodology.

10 Q: How have Aquila's working capital needs been determined for its Iowa
11 gas utility operations?

12 A: In contrast to the unapproved method Aquila proposes, Iowa has long relied
13 upon a comprehensive analysis of the timing of each utility's incoming
14 revenues and outgoing payments to determine working capital needs.

15 Q: When was Aquila's working capital needs for its Iowa gas utility
16 operations last reviewed?

17 A: OCA witness Mr. Fasil Kebede filed testimony regarding Aquila's incoming
18 revenues and its various outgoing payments in RPU-02-5. This case was
19 ultimately settled in February, 2003.

20 Q: What was the result of Mr. Kebede's comprehensive review of Aquila's
21 incoming revenues and outgoing payments?

1 A: According to Mr. Kebede's analysis summarized on Schedule D, Aquila's
2 working capital balance for its Iowa operations is approximately a negative
3 \$1.5 million. That is, Aquila already has surplus working capital in Iowa. As
4 a result of this analysis, Mr. Kebede concluded Aquila does not need any
5 additional working capital for its Iowa gas utility operations.

6 Q: Has Aquila demonstrated that the loan agreement is better for its Iowa
7 utility customers than bankruptcy or selling its Iowa utility assets?

8 A: No. Aquila has not demonstrated how its efforts to avoid bankruptcy are
9 better for its Iowa utility customers. Aquila did, however, note its long-term
10 strategy was to retain its domestic utility operations and that selling these
11 assets would be inconsistent with that strategy.

12 Q: Has Aquila demonstrated that this loan does not harm its Iowa utility
13 customers?

14 A: No. Aquila has not provided any testimony, analysis or other support to
15 demonstrate that this loan does not harm its Iowa utility customers.

16 Q: Has Aquila demonstrated any benefit to its Iowa utility customers of
17 encumbering its Iowa utility assets?

18 A: No. Aquila has not shown how this loan, which encumbers its Iowa utility
19 assets as collateral, would benefit its Iowa utility customers.

20 Q: Would a .75% drop in the interest rate on this loan discussed by Mr.
21 Dobson benefit Aquila's utility customers?

1 A: No. The interest rate on the three-year term loan drops from 8.75% to 8.0 if
2 Aquila receives approval to pledge additional utility assets. Even if this loan
3 were reflected in rates, which it is not, rates should reflect only prudently
4 incurred costs associated with an investment grade rating. Since the interest
5 rate on this loan is not reflected in rates, there is little, if any, direct benefit to
6 its utility customers.

7 Q: What is the current rate on a debt issued by a prudently managed utility
8 with an investment grade rating?

9 A: Entergy, for example, issued five year first mortgage bonds with a coupon of
10 4.35% earlier this year. Entergy has an investment grade bond rating of Baa.
11 As of the end of May, long-term utility bonds rated Baa were yielding 6.39%.

12 Q: Has Aquila made assurances in this docket that it would not seek to re-
13 cover the excessive capital costs it incurs from its utility customers?

14 A: Yes. However, ongoing and previous assurances have not been reflected in
15 Aquila's actions. Aquila, for example, also made assurances that it only
16 allocates the capital and costs associated with utility operations to its captive
17 utility customers in previous rate case filings.

18 Q: Has Aquila's internal allocation of its capital balances and costs in the
19 past protected utility customers from undue costs?

20 A: No. Aquila has consistently attempted to shift unwarranted costs to its Iowa
21 utility customers in its internal allocation of capital. For example, in Aquila's

1 last gas case in Iowa, RPU-02-5, Aquila attempted to assign higher cost debt
2 and more equity to its low risk Iowa utility operations with their stable cash
3 flows than to its riskier unregulated operations. Higher cost debt and more
4 equity is associated with riskier investment, but Aquila's internal assignment
5 ignore this financial reality. This can be seen on Schedule E which compares
6 Aquila's actual capital structure and the more costly capital structure it
7 internally allocated to its Iowa utility customers in RPU-02-5.

8 **Q: Has the Board ever set rates based on Aquila's internal assignment of**
9 **capital and costs?**

10 **A: No. Rates have never been based on Aquila's internal allocations and**
11 **assignments of its capital costs.**

12 **Q: Does Aquila claim that the three-year loan is in the public interest?**

13 **A: Yes. Aquila does claim in its Application filed with the Iowa Utilities Board**
14 **dated April 30, 2003 that the ability to secure the most favorable terms**
15 **available to it "is in the public interest." Aquila's claim that the three-year**
16 **loan is in the public interest is contradicted by Aquila's acknowledgment in**
17 **this same document that the pledge of its regulated utility assets in Iowa is for**
18 **"the benefit of its lenders."**

19 **Q: Does the short-term loan benefit any others?**

20 **A: Yes. Though unsaid, avoiding bankruptcy also benefits its current equity**
21 **owners. The current equity owners would likely lose all of their investments**

1 in a bankruptcy proceeding. The current equity owners include the Green
2 family whose leadership at Aquila has led to this credit crisis. The Green
3 family's control of Aquila is ongoing. The loan itself maintains the Green
4 family's control and postpones Aquila's need to declare bankruptcy, even if
5 this were contrary to the interest of its Iowa utility customers.

6 **Q: Is a financially weakened utility owner such as Aquila in the public**
7 **interest?**

8 **A:** No. As Aquila noted in its Application before the Missouri Public Utility
9 Commission, "The public interest is not benefitted by financially weakened
10 utilities."³

11 **Q: Is an investment grade credit rating of BBB sufficient to protect Aquila's**
12 **regulated utility customers?**

13 **A:** Yes. A BBB rating was adequate when Aquila was a primarily a plain utility.
14 But, this rating was, as is now obvious, inadequate protection for its Iowa
15 utility ratepayers when Aquila expanded its commingled and higher risk
16 unregulated operations. Aquila's ongoing commingling of the financial
17 obligations of its regulated utility with its other unregulated operations makes
18 even the goal of again achieving a BBB credit rating more difficult.

3. Application of Aquila for Authority to Assign, Transfer, Mortgage or Encumber
its Franchise, Works or System filed with the Missouri Public Service
Commission April 30, 2003, p. 8.

1 Q: Why does Aquila's request to pledge its Iowa utility assets as collateral
2 harm its customers?

3 A: Aquila's proposal to pledge its Iowa utility operations as collateral harms its
4 Iowa utility customers because it unnecessarily encumbers its Iowa utility
5 operations for a loan that is not needed for its Iowa operations, [REDACTED]

6 [REDACTED]
7 [REDACTED]. Aquila's

8 proposal to pledge its Iowa utility assets as collateral also continues to leave
9 these operations at risk and does not address the underlying cause of this
10 financial crisis: Aquila's commingled regulated and unregulated finances.
11 Iowa utility customers would be better protected if Aquila would separate its
12 utility financing from its non-utility financing as many utility companies do.
13 Aquila's proposal does not accomplish this [REDACTED]

14 [REDACTED]

15 Q: Can the harm that Aquila's corporate structure creates be quantified?

16 A: Yes, but only in part. For example, Aquila has already spent \$21 million to
17 restructure its operations since Enron's collapse into bankruptcy in December
18 2001, ostensibly to gain efficiencies and transparency that its failed
19 unregulated operations will not have an impact on its ability to provide
20 service to its ratepayers in the future. These costs could have been avoided
21 had Aquila first insulated its regulated utility operations from its unregulated
22 and riskier operations.

1 Q: Are Aquila's utility customers harmed even if these costs do not directly
2 show up in their rates?

3 A: Yes. Instead of incurring these costs, Aquila could, but won't be able to now,
4 pay down some of the legacy debt associated with its failed unregulated
5 investments. This would have led to Aquila regaining an investment grade
6 bond rating sooner. An investment grade bond rating best assures utility
7 operations access to capital in the future when it is needed at reasonable costs.

8 Q: Should the Board allow Aquila to pledge its Iowa utility assets as
9 collateral for a working capital loan?

10 A: No. The Board should reject Aquila's request to encumber its Iowa utility
11 assets for this loan which is not needed for working capital in Iowa,
12 unnecessarily encumbers and restricts future options that would be in its
13 ratepayers' interest and has made ratepayers worse off. At the least, Board
14 approval of Aquila's proposal should require Aquila to effectively insulate its
15 regulated utility and unregulated finances as most utilities already do under a
16 holding company with a separate utility subsidiary or agree to sell its Iowa
17 utility assets at the end of the three-year loan.

18 Q: Will Aquila still have access to funds from this loan even if the Board
19 denies this proposal to pledge its Iowa utility assets as collateral?

20 A: Yes. Aquila was only required to make a reasonable efforts to gain regulatory
21 authority to pledge additional utility properties as collateral to satisfy this loan

1 agreement. The loan agreement was not contingent on receiving this
2 approval.

3 **Q: Would you summarize your testimony?**

4 **A:** Yes. Based on my review, Aquila's request to pledge its Iowa utility assets as
5 collateral is for the benefit of its lenders and the current equity owners rather
6 than its Iowa utility customers. Aquila's proposal fails to address the
7 underlying factor responsible for this financial crisis: Aquila's continued
8 commingling of its regulated and unregulated financing. Aquila's proposal is
9 also based on an unapproved and erroneous procedure to determine its Iowa
10 utility working capital needs separate from a review of its other costs and
11 sources of revenues to cover those costs. Aquila's Iowa utility operations
12 already support a surplus of working capital. Aquila's proposal to pledge its
13 Iowa utility assets as collateral for this loan which is not needed for its Iowa
14 utility operations and that may be used to support Aquila's other operations,
15 including its unregulated operations, is not in its Iowa utility customers'
16 interest or the public interest. It is also not in the interest of Aquila's Iowa
17 utility customers or the public interest to have Iowa utility operations and vital
18 services dependent on a financially distressed firm that continues to fail to
19 correct the structural flaws that created this credit crisis that now puts its
20 utility operations at risk.

21 **Q: Does this conclude your direct testimony?**

22 **A:** Yes, it does.