MISSOURI PUBLIC SERVICE COMMISSION'S
STAFF REPORT ON
AQUILA, INC.

DECEMBER 2002

TABLE OF CONTENTS

Section 1: Overview-Executive Summary

The Missouri Public Service Commission directed its Staff to review and report on the evolving financial situation at Aquila, Inc. and the implications that situation has on Aquila's regulated operations in Missouri. Aquila's Missouri regulated operations consist of separate service areas for electric and natural gas service certificated to Aquila, Inc. d/b/a Aquila Networks-MPS (MPS, formerly UtiliCorp United Inc. d/b/a Missouri Public Service), Aquila, Inc. d/b/a Aquila Networks-L&P (L&P, formerly UtiliCorp United Inc. d/b/a St. Joseph Light & Power) and steam heating service certificated under L&P. MPS and L&P are divisions of Aquila. Aquila acquired L&P through a $282 million merger at the end of 2000.

The Staff was to prepare a report of the information relevant to the Commission's inquiry. The report was to be submitted to the Commission by the beginning of December 2002. There is no discussion of any open case included in this report. Any issues regarding Aquila's financial condition relevant to those cases will be addressed in each of the specific cases. This includes any open Purchase Gas Adjustment (PGA) and Actual Cost Adjustment (ACA) case.

Following Enron's collapse last year, many energy companies have suffered from falling power prices, decreased trading activity and lowered investor confidence, as well as an industry-wide credit squeeze. This situation has had a significantly negative impact on Aquila's financial condition, forcing it to sell assets, cut costs and seek other means to raise cash. Aquila's deteriorating financial condition has created a significant and growing level of concern regarding the ultimate impact of this situation on Aquila's Missouri regulated utility operations. This concern increases over time as Aquila's financial condition fails to stabilize and continues to be challenged. The consequences to Missouri's regulated operations resulting from all these changes are becoming an issue to a growing number of people. All of these changes are increasingly important to consumers served by Aquila, the investment community and the Missouri Public Service Commission. In its work during the past several weeks, the Staff has been seeking information to gain a greater and more detailed understanding of Aquila's current financial position, its provision of customer service and its future ability to provide safe and reliable service at just and reasonable rates. The Staff does not know the ultimate impact of Aquila's financial troubles, but will address, in this report, the options the Commission has available to it to effectively handle any potential negative impacts that Aquila's financial troubles may have on its Missouri operations.

History has shown that no one has publicly been able to predict the next change to Aquila's financial condition. The Staff unfortunately cannot put an end to the speculation and opinion that is certain to continue to evolve with any new negative information regarding Aquila's financial condition. While it is not the Staff's intent through this report to add to the level of speculation and opinions regarding Aquila's ultimate financial outcome, Staff must still proceed with its investigation and has done so.

Staff has initiated the process of monitoring, identifying, evaluating and documenting potential negative implications from the deterioration of Aquila's financial condition. This report provides the results of Staff's review and examination of Aquila's Missouri regulated operations. The Staff will recommend to the Commission enforcement options be exercised whenever suitable arrangements cannot be made with Aquila to address an immediate concern. Staff currently has two Data Requests (DRs) still outstanding, is awaiting updates on two more and needs additional time to review information just recently received from Aquila due to training and other cases. Staff will do a supplement to this report as circumstances warrant or as directed by the Commission.

Section 2: Background

A. Aquila Before the Enron Collapse

This section provides background material regarding the entity now called Aquila.

Aquila's Corporate Structure and Operations

Aquila was founded in 1917 as Green Light and Power Company. This operation grew into the provision of electric, natural gas and water regulated services in Missouri. Aquila changed its name to the Missouri Public Service Company (MPS) in 1927, to UtiliCorp United, Inc. in 1985 and finally to Aquila in 2002. Aquila maintains its headquarters at 20 West 9th Street in Kansas City, Missouri.

Between 1985 and 2002, Aquila grew from a medium-sized electric utility to an international energy and risk management company into one of the largest wholesalers of electricity and natural gas in North America. By 2002, Aquila owned and operated electrical and natural gas distribution networks in seven states of the United States of America as well as distribution networks in Canada, New Zealand and Australia. As of December 31, 2001, Aquila had total assets of $12 billion and annual sales of $40 billion. The chart below shows the growth in Aquila's assets and sales over the past eleven years.

	Assets	Sales
1991	$2,400,000,000	$1,700,000,000
1992	$2,500,000,000	$2,300,000,000
1993	$2,800,000,000	$2,700,000,000
1994	$3,100,000,000	$2,400,000,000
1995	$3,900,000,000	$2,800,000,000
1996	$4,700,000,000	$4,300,000,000
1997	$5,100,000,000	$8,900,000,000
1998	$6,100,000,000	$12,500,000,000
1999	$7,500,000,000	$18,600,000,000
2000	$14,100,000,000	$29,000,000,000
2001	$12,000,000,000	$40,000,000,000

In 2001, Aquila was organized and managed as four business segments. These business segments were: 1) Energy Merchant, 2) U.S. Networks, 3) International Networks, and 4) Services. In November 2001, Aquila combined its U.S. Networks segment and its International Networks segment into the Global Networks business segment.

Energy Merchant Business Segment

Aquila's Energy Merchant business segment provided risk management products and services, traded energy-related and other commodities, and marketed natural gas and electricity to industrial and wholesale customers in the United States and Canada. Merchant Services also marketed energy in Europe through its offices in the United Kingdom, Germany and Norway. In 2001, Aquila's merchant services business had $37.7 billion in sales, which accounted for 94% of Aquila's total sales, and contributed 65% of Aquila's earnings before interest and taxes (EBIT). At December 31, 2001, Merchant Services had $6.2 billion in assets, or 52% of Aquila's total assets. The energy-trading component of Merchant Services (the business recently exited by Aquila) alone accounted for 90% of total company revenue, which made it one of the top trading companies in the United States.

U.S. Networks Business Segment

As a component of its Global Networks Group, Aquila's U.S. Networks' operating divisions in the U.S. serves approximately 349,000 electric distribution customers in three states: Missouri, Kansas and Colorado; and 831,000 natural gas distribution customers in seven states: Missouri, Kansas, Colorado, Nebraska, Iowa, Michigan and Minnesota. Its seven domestic utility divisions are Aquila Networks-MPS, Aquila Networks-L&P, Kansas Public Service, Peoples Natural Gas, WestPlains Energy, Northern Minnesota Utilities and Michigan Gas Utilities.

In 2001, U.S. Networks had approximately $2.3 billion in sales, which accounted for 5.6% of total company sales, and contributed 16.7% of total company EBIT. At December 31, 2001, U.S. Networks had $3.5 billion in assets, or 29.4% of total company assets.

International Networks Business Segment

The second component of Aquila's Global Networks Group, Aquila's International Networks operated electric and gas utility networks in Australia, New Zealand and Canada. Aquila managed and was 34% owner of United Energy in the Australian State of Victoria. United Energy has four business units: Distribution, Energy Merchant, Utili-Mode and UeComm. The Distribution unit serves 1.1 million electricity and gas customers in Melbourne and the Mornington Peninsula. UeComm, a telecommunications business, has developed networks in Sydney, Melbourne and Brisbane. Utili-Mode offers energy-related "back office" services including call center, billing, metering and account collection functions. The Energy Merchant business buys and sells electricity in the wholesale market, trades related commodities, and sells risk management products.

Aquila and United Energy jointly own 45% of AlintaGas Limited, a natural gas distributor in the state of Western Australia. AlintaGas is based in the city of Perth and has more than 430,000 customers.

Aquila owned 55% of UnitedNetworks Limited (UnitedNetworks), a company that serves approximately 600,000 customers, mostly in the Auckland and Wellington areas. UnitedNetworks is one of New Zealand's largest network infrastructure companies, distributing energy to about 30% of the country's electricity consumers and more than half of New Zealand's natural gas consumers. It also owns and manages a telecommunications networks business. Aquila created UnitedNetworks in 1998 by combining the electrical distribution operations it acquired from three different New Zealand utilities, and later a natural gas network. On October 11, 2002, Aquila announced the sale of UnitedNetworks with its share of the proceeds estimated to be approximately $362 million.

Aquila has been operating in Canada since its acquisition of West Kootenay Power in 1987. In February 2000, Aquila acquired TransAlta Corporation's distribution and retail operations in Alberta for $480 million. Aquila operates this business as Aquila Networks Canada (Alberta), Ltd.

In 2001, Aquila's International Networks unit had approximately $354 million in sales, which accounted for less than 1% of Aquila's total sales, and contributed 17% of Aquila's EBIT. At December 31, 2001, International Networks had $1.9 billion in assets, or 16% of total Company assets. The major change in Aquila's International Networks business is the sale of its utility operations in New Zealand. On a going-forward basis, Aquila's International Networks business will consist only of its utility businesses in Australia and Canada.

Services Business Segment

In 2001, this segment primarily consisted of Quanta Services and Aquila Communications Services. During 2001, (Aquila held a 38.5% equity interest in Quanta Services, a Houston-based firm that builds and maintains networks carrying energy and telecommunications. In 2001 and the beginning of 2002, Aquila spent considerable time and resources trying, unsuccessfully, to achieve control over Quanta's operations.

Formed in early 2000, Aquila Communication Services provided a range of broadband services including local and long-distance voice, high-speed Internet access and digital television. Aquila's current efforts are concentrated in the Midwest region in partnership with Unite, a competitive local exchange carrier serving an area north of Kansas City, and Everest Connections Corporation, a St. Louis-based telecommunications company involved in the construction and operation of broadband fiber-optic networks to homes and businesses. During 2001, Aquila decided to limit its fiber-optic communications business to the Kansas City market. As a result, it wrote off $16.5 million related to network design, long-term leases and other development costs related to markets outside of Kansas City that it does not intend to develop.

B. Aquila Following the Collapse of Enron

The financial collapse of Enron saw the beginning of significant impacts on the utility industry and, specifically, certain electric companies. Aquila was a company that was significantly impacted following Enron's financial demise. Enron formalized its financial collapse by filing for bankruptcy on December 2, 2001. The impacts upon Aquila of the Enron financial collapse can be illustrated by the change in Aquila's debt credit ratings.

There are three credit rating agencies that rate the quality of the debt issued by various entities, including utilities. These credit rating agencies are Standard and Poor's, Moody's and

FitchRatings. At that time of the Enron bankruptcy filing, Aquila (now Aquila) had the following credit ratings:

<u>Fitch</u>	<u>BBB, Negative Watch</u>
<u>Standard and Poor's</u>	<u>BBB, Stable Outlook</u>
<u>Moody's</u>	<u>Baa3, Stable Outlook</u>

Credit rating agencies established higher financial thresholds for investment-grade companies after Enron's collapse. Aquila determined that under the new market conditions and more stringent requirements recently established by credit rating agencies, it did not have sufficient liquidity to continue in the trading business in its Energy Merchant Business segment. Aquila indicated that by some estimates it would require $2.5 billion in cash or readily available marketable securities in order to continue its trading operations.

Aquila has indicated that the rating agencies began expressing concern regarding its credit rating early in 2002. On February 27, 2002, FitchRatings downgraded Aquila credit rating to BBB- with a stable outlook. The rating downgrade was cited as due primarily to Aquila's increasing dependence upon cash flows derived from its merchant energy business. (Aquila Merchant Services, Inc.) This downgrade took into consideration the merchant energy business' reliance on the parent company for funding and the merchant energy business' need for funds to support its ongoing internal growth and high capital expenditures related to merchant generation and gas storage.

Aquila's financial problems attracted greater public notice with the announcement in April 2002 by Moody's Investors Services that it was changing Aquila's outlook to negative. In response to this action, Aquila issued a press release on April 29, 2002, describing its current focus on its balance sheet and investment grade rating. In this press release, Aquila stated that it had taken a number of positive steps over the past 12 months to strengthen its balance sheet and liquidity position. Aquila announced that it has issued over $1 billion in equity, planned to sell $500 million in less strategic assets, and was implementing cost-cutting and revenue-enhancement measures with a goal of increasing earnings by $100 million. This initiative became known as Project BBB+/Baa1. This effort was intended to establish Aquila with an investment grade debt rating from both Standard and Poor's and Moody's.

In addition to these actions, Aquila responded by reducing costs approximately $100 million, exiting the energy trading business, lowering its common stock dividend by 42%, issuing $800 million of equity and debt to improve liquidity, establishing new revolving credit lines, canceling the announced purchase of Cogentrix and selling assets as part of a $1 billion divestiture program. Aquila initiated these actions to improve its credit rating and to strengthen its balance sheet, and to meet Moody's and Standard and Poor's credit metrics requirements. Aquila referred to this effort as part of its "Project BBB+/Baa1."

On May 21, 2002, Moody's Investors Services placed Aquila under review for possible downgrade. In a press release issued on that date, Robert K. Green, Aquila's then President and Chief Executive Officer stated, "We've maintained an open dialogue with Moody's and made them aware of our plans to improve cash flow. We've already identified approximately $96 million in savings as a result of staff reductions, elimination of executive incentives and a tightening on all expenditures. We expect to make significant progress in short order."

The next day, May 22, 2002, Aquila announced that it was eliminating approximately 200 positions from its Merchant Services and Corporate staffs. This staff reduction was in addition to the elimination of 500 positions upon completion of the previously announced restructuring of its Networks business.

On June 17, 2002, Aquila announced a new three-part plan including: (1) a significant reduction and downsizing of its wholesale energy services business in response to the increased cost of capital for that business; (2) an anticipated $.50 per share reduction in the annual common dividend to a new rate of $.70 per share; and (3) the issuance of $900 million of new equity and debt securities in order to balance the capital structure and satisfy Aquila's remaining 2002 liquidity needs, including the funding of previously announced acquisitions.

On August 5, 2002, Standard and Poor's reaffirmed Aquila's credit rating of BBB with CreditWatch Negative, following cancellation of the proposed acquisition of Cogentrix Energy, Inc. Standard and Poor's cited the cancellation as positive for the credit quality of Aquila, but it would not immediately affect the current rating or outlook for Aquila. Aquila had been placed on CreditWatch with negative implications when the Cogentrix transaction was announced.

On August 6, 2002, less than a month after it announced that it would restructure the wholesale energy marketing and trading business of its Merchant Services segment, Aquila announced that it was totally eliminating all wholesale energy marketing and trading.

On August 16, 2002, Aquila released information outlining initiatives taken in the past six months that had favorable implications for its risk profile, cash flows and credit ratings. These actions included:

- Terminating the Cogentrix acquisition
- Reducing its dividend by 42%
- Exiting from the wholesale energy trading business
- Completing equity and debt offerings totaling $764 million in proceeds
- Identifying over $100 million in cost reductions
- Targeting over $1 billion in asset sales

On August 19, 2002, FitchRatings revised Aquila's Rating Outlook to Negative from Stable based on its ongoing review of Aquila's liquidity and financial flexibility at a time when Aquila was shedding business lines and assets.

On September 3, 2002, Moody's downgraded Aquila to Ba2 with a Stable outlook. According to Aquila, Moody's cited execution risk on the asset divestiture program as a major concern. Earlier in the year, Moody's had threatened to downgrade Aquila's credit rating due to its deteriorating financial situation. Moody's rating of Ba2 is considered non-investment grade or "junk." Moody's downgrade meant that Aquila had to pay $192 million in obligations within 60 days to cover financial triggers tied to its credit ratings.

On September 4, 2002, Standard and Poor's downgraded Aquila's credit rating to BBB- with Outlook Negative. According to Aquila, Standard and Poor's acknowledged execution risk related to the asset divestiture program but was willing to give management more time to implement its plan. Standard and Poor's action confirmed Aquila's investment grade credit rating and removed Aquila from credit watch. This action by Standard and Poor's moved Aquila's credit rating to BBB- from BBB and placed Aquila on negative outlook. As a part of its credit assessment, Standard and Poor's stated that to maintain credit quality in the triple-B range, Aquila must complete asset sales, further reduce business risk and improve utility operations.

On October 1, 2002, Aquila's President and Chief Executive Officer Robert Green resigned from all executive officer positions with Aquila and from its board of directors. Robert Green's separation package had a value of approximately $7.6 million. The board reassigned Robert Green's CEO responsibilities to longtime Chairman Richard C. Green, Jr.

On October 16, 2002, Aquila reported additional asset sales under its previously announced restructuring program, bringing the current total of assets it has sold or agreed to sell to $976.6 million. Aquila's stated goal is to sell at least $1 billion in assets to strengthen its balance sheet and credit. Aquila's Chairman, President and Chief Executive Officer Richard C. Green, Jr. stated that: "We are continuing to focus on our transition back to our roots as a regulated utility company and our exit from the elements of our previous energy merchant strategy that are not consistent with our current business model."

In early November 2002, Aquila announced it had wrapped up the first phase of bidding for sale of Midlands. They expect the next phase, binding offers, to be completed in November. Aquila stated that Midlands is the last asset it will have for sale and that it would not sell it at a loss or have a "fire sale." Aquila also stated it did not need the sale of Midlands to meet its goal of selling $1 billion in assets.

On November 13, 2002, as part of its ongoing transition plan, Aquila announced that its board of directors has suspended the quarterly cash dividend on Aquila common stock for an undetermined period. The board reached this decision after the new management team completed a detailed analysis of Aquila's current financial condition. Suspension of the dividend is part of Aquila's strategy to achieve its goal of strengthening its credit profile. In the press release, Richard C. Green, Jr., stated that Aquila plans to do more than simply survive, and that "Aquila's liquidity is sufficient to ensure that Aquila can continue to operate safe and reliable utility networks and maintain quality customer service. This remains a healthy core business."

Also on November 13, 2002, Aquila reported a Third Quarter loss. Aquila also announced that as a result of its operating performance, the winding down of merchant energy businesses and the asset sales program, that it does not expect to be in compliance with an interest coverage requirement contained in certain financial arrangements until December 31, 2003. According to Aquila's 10Q filing with the Securities and Exchange Commission, as of September 2002, Aquila's revolving credit agreement is the only obligation on its balance sheet that contains these interest coverage ratio provisions.

Aquila has obtained a waiver from this requirement that will expire on April 12, 2003. Aquila has agreed to make certain payments to the financial institutions, to limit its dividends, to have lower borrowing capacity under its revolving credit agreements, and to use reasonable efforts to obtain approvals from regulators that would allow it to pledge its domestic regulated assets as collateral. Aquila agreed to renegotiate its bank financing arrangements prior to the waiver's expiration. In Aquila's September 30, 2002, 10Q filing Aquila noted that, because of the downgrade in its credit rating to Ba2 by Moody's, the interest rate on $500 million of senior notes due 2012 increased from 11.875% to 13.125% and the interest rate on $250 million senior notes due 2011 increased from 7.95% to 8.70%.

On November 13, 2002, the prior ratings actions had resulted in the following credit ratings for Aquila:

- Fitch BBB-, Negative Watch
- Standard and Poor's BBB-, Negative Outlook
- Moody's Ba2, Stable Outlook

Both Fitch's and Standard and Poor's ratings were still considered investment grade. Aquila expected no additional ratings actions from either Standard and Poor's or Moody's until early 2003, when Aquila completes its asset divestiture program and finalizes its 2002 financial results.

Aquila asserted that its lowered credit ratings were not unique, stating that Moody's currently rates over 20 U.S. utilities as sub-investment grade and those utilities are continuing to provide safe and reliable service. Lower credit ratings can impact a company's cost of capital, and Aquila admits that its marginal cost of capital has increased. Deterioration of credit quality for diversified energy companies and events, such as the Enron collapse, has made access to capital markets more difficult. It has also made what access is available more expensive.

As an example, Aquila sold unsecured notes with a 30-year maturity at a coupon rate of 7.875% as of March 2002. As of July 2002, it sold notes with a 10-year maturity at a coupon rate of 11.875%. In a normal interest rate environment, shorter-term notes pay a lower coupon than longer-term notes. The longer-term notes typically require a higher coupon to compensate the note purchaser for interest rate risk (the risk of interest rates rising while an investor is locked in long-term at lower rates). In Aquila's case, its short-term rates were higher than its long-term rates just three months prior.

Aquila claims that the impact of higher capital costs is mitigated by the fact that it does not expect to be a "net borrower" over the coming months. Aquila asserts that it intends to use the proceeds from the $1 billion divestiture program to reduce debt and have targeted repurchase of the 11.875% notes (now 13.125%) given their higher interest rate.

Additional credit rating actions took place in 2002. On November 15, 2002, Fitch announced the downgrade of Aquila's senior unsecured rating to BB from BBB- and placed Aquila on Rating Watch Negative. This action was taken pending a comprehensive review of the outlook for the remaining core business and the refinancing of credit facilities now set to come due on April 12, 2003. Subsequent to the downgrade, Aquila announced that with liquidity at close to $900 million, it is prepared to respond to the potential effects resulting from the downgrade.

On November 19, 2002, Standard and Poor's downgraded Aquila to BB from BBB-. The outlook remains negative. The downgrade reflects the slower-than-expected recovery of its credit quality as Aquila exits the merchant energy business and recent financial results that revealed lower than anticipated operating cash flows and higher debt leverage numbers. Standard and Poor's stated that the numbers were weaker than expected and that Aquila's financial plan has not provided the level of sustainable cash flow necessary for investment-grade status. Aquila responded to the downgrade with an announcement that its liquidity was sufficient to meet the cash needs resulting from the downgrade without affecting its operations. According to Aquila's September 30, 2002, 10Q, because of the downgrade of the Aquila's credit rating to BB by Standard and Poor's, the interest rate on $500 million of senior notes due 2012 increased from 13.125% to 14.375% and the interest rate on $250 million senior notes due 2011 increased from 8.70% to 9.45%. Aquila stated that the downgrade could potentially trigger approximately $238 million in additional demands for cash.

There were several factors creating demands for cash after the Standard and Poor's downgrade. Aquila stated that $84 million in four series of Australian denominated bonds guaranteed by Aquila have provisions that could require Aquila to repurchase the bonds if the bondholders choose to exercise that option in the next 30 to 60 days. Aquila also has a tolling agreement that could require Aquila to post $37 million in additional collateral within 70 days to eight months of a Standard and Poor's downgrade. Tolling agreements allow Aquila to generate power at plants owned by others in exchange for the natural gas that fuels the plants. Another approximately $23 million would need to be posted to cover standard margining agreements remaining from Aquila's discontinued wholesale energy merchant business. There is also the potential that Aquila may be required to post additional collateral of up to $94 million related to certain commodity contracts.

After the Standard and Poor's announcement, Aquila's credit ratings were as follows:

- Fitch — BB, Negative Watch
- Standard and Poor's — BB, Negative Outlook
- Moody's — Ba2, Stable Outlook

Aquila no longer had an investment grade rating from any rating agency.

Further downgrades by Moody's below Ba3 or by Standard and Poor's below BB-, may require Aquila to post an additional $73 million in collateral. Any downgrade below Moody's current rating of Ba2 results in a .25% increase in interest on both sets of notes previously mentioned. Any downgrade below Standard and Poor's current rating of BB results in a 1.50% increase in interest on the $500 million, 2012 notes, and a 1.00% increase in interest on the $250 million, 2011 notes.

C. Possible Negative Impacts of Recent Financial Activity on Missouri Regulated Operations

The Staff has attempted to identify possible negative impacts of all this activity on the rates charged and the quality of service provided to Aquila's Missouri electric and gas consumers. Subsequent sections will provide possible safeguards or Staff actions to mitigate these concerns. Specific concerns are whether: 1) the higher capital, interest and restructuring costs will lead to higher utility rates; 2) the reduced access to funds will reduce the quality of service; and 3) the employee reductions will produce service and safety issues. Another concern could be identification of future proceedings that require expertise that presently does not reside within the Missouri Public Service Commission and its Staff.

One of the initial steps to protect consumers from the negative cost of service impacts of these actions is to identify and document the specific negative items that can have possible detrimental impacts on Aquila's Missouri operations. At this time, Staff has identified the higher capital and interest costs as possible negative impacts on Aquila's Missouri regulated utility rates. These costs have already been noted as a result of the downgrade of the Aquila's debt ratings below investment-grade status. As a result of the downgrade of Aquila's credit rating by Moody's on September 3, 2002, and by Standard and Poor's on November 19, 2002, the interest rate for $500 million in senior notes for Aquila was increased from 11.875% to 14.375%. The interest rate on an additional $250 million of debt increased from 7.85% to 9.45%. These rates will be increased again if Aquila is further downgraded by Standard and Poor's or Moody's.

Another negative cost of service item is the restructuring costs. The cost to Aquila of the restructuring actions was approximately $188 million for the nine months ended September 30, 2002. These restructuring charges include $54.1 million in severance costs related to the elimination of approximately 1,630 employees (including employees transferred with the sale of businesses). Approximately 1,120 Merchant Service employees, 80 corporate employees and 430 Domestic Networks employees were terminated.

Also included in the $188 million restructuring charges were $28.9 million in employee retention payments, $36.7 million in abandoned lease agreements, $59.2 million in the write-down of leasehold improvements and equipment previously used in the wholesale energy trading business and $7.1 million loss on sale of Aquila's corporate aircraft.

Another possible negative impact is the accounting treatment for losses related to non-regulated property. For example, Aquila has reduced its ownership interest in Quanta Services from a high of 38% to 14% as of October 2002. Quanta's stock price has decreased significantly from Aquila's cost basis of $26.69 to less than $3 per share. This reduction in Quanta's stock price has caused Aquila to write down its investment in Quanta by $698.1 million in the nine months ended September 30, 2002. Aquila expects to dispose of its remaining Quanta shares prior to December 31, 2002.

In its continuing transition from an energy merchant to an integrated utility, Aquila expects to record in the fourth quarter of 2002 significant charges relating to contract renegotiations, the continued exit of wholesale commodity positions, potential losses on sale or impairment of assets and additional severance costs.

The financial effects of Aquila's operating performance, the winding down of its wholesale energy trading business and its asset sales program have caused Aquila to not be in compliance with certain debt agreements with its lenders. The impact of future developments from this condition could result in proceedings before the Commission that are unprecedented and require expertise not readily available to the Agency. These debt agreements require that Aquila's earnings before interest, taxes, depreciation and amortization (EBITDA) during the previous four quarters must be at least 2.25 times its interest expense during this period. This is referred to as an interest coverage ratio. Aquila does not expect to be in compliance with these debt agreements until at least December 31, 2003.

However, Aquila obtained waivers from the affected lenders from the requirement to comply with its interest coverage ratio from September 30, 2002, until April 12, 2003. In exchange for this waiver, Aquila paid down approximately $158.6 million in debt. Aquila further agreed that 50% of any net cash proceeds it receives from the sales of assets under $1 billion and 100% of any net cash proceeds from any further sales of its North American assets above $1 billion dollars received prior to April 12, 2003, would be used to reduce its obligations to these lenders on a pro rata basis. Aquila agreed to make reasonable efforts to obtain approvals from regulators to allow Aquila to use certain of its regulated assets as security for the benefit of its lenders. In addition, Aquila was required to pay fees of approximately $2.4 million to the lenders in connection with these waivers. Should the waiver obtained by Aquila not be extended beyond April 12, 2003, and the affected lenders demand payment in full, substantially all of Aquila's remaining debt would become due and payable. Aquila would not have the liquidity to meet these obligations as they become due and will be in default. Aquila is continuing to work with its lenders to reach an agreement before the expiration of the current waivers.

The changes that have occurred at Aquila over the last year have created conditions that can be detrimental to the operation of Aquila's Missouri regulated properties. The Staff has identified the need to monitor the situation and identify areas that may potentially be or currently are potential problems. This monitoring will include the review of external sources and responses to Data Requests. Negative items will be identified and addressed in the appropriate venue based on the specific facts and circumstances. The details of the specific areas impacting rates, quality of service and safety are provided in the following sections of this report.

Section 3: Rates and Cost of Service Issues

Aquila's last rate case was filed before this Commission in June 2001 and sought an annual increase of $49.4 million. Aquila's filing was primarily driven by rising fuel costs. This Commission docketed the filing as Case No. ER-2001-672. As the rate case progressed, MPS's fuel costs dropped significantly. The rate case eventually was settled through a unanimous stipulation and agreement in February 2002 for an annual rate decrease of $4.3 million.

While Aquila's financial problems are significant and these problems are expected to continue through the next year, there is no immediate threat to Aquila's Missouri ratepayers through an increase in rates. If Aquila files for a rate increase for its MPS or L&P service areas, to recover Aquila's higher costs related to problems generated from its nonregulated business operations, the Commission has several ratemaking options it can employ to prevent a negative impact on Aquila's Missouri ratepayers.

To prevent or mitigate Aquila's higher cost of capital from being charged to Missouri ratepayers, the Commission can order the use of a hypothetical capital structure for ratemaking purposes to determine the appropriate mix of debt and equity that is appropriate for MPS and/or L&P. This capital structure would not be dependent on the capital structure currently in effect for Aquila. Aquila's response to the actions of rating agencies and other members of the financial community, while it may be appropriate for Aquila given its current situation, may not result in a capital structure that is appropriate and reasonable for its MPS and L&P utilities. Also, as described above, Aquila's debt costs have increased to a significant extent as a result of actions by rating agencies. The Commission could determine that this higher cost of debt, and potentially higher equity costs should not be passed on to Missouri ratepayers. Instead of using

Aquila's actual cost of debt and equity, the Commission could impute debt and equity rates that it considers reasonable for Aquila's Missouri utilities.

In Aquila's current financial environment, there is an incentive for Aquila to keep liabilities off its balance sheet. This incentive may lead to Aquila acquiring new generation capacity through an accounting mechanism known as an operating lease instead of purchasing the generation assets and recording the acquisition on its balance sheets as an asset and liability on the balance sheet. Under an operating lease, an entity does not record an asset and resulting liability on the balance sheet but only charges periodic lease payments as an expense in the income statement. Under certain conditions an operating lease may be the lowest cost method of acquiring additional capacity in the short run; however, in certain situations it may result in significantly higher costs in the long run than recording the acquisition under the traditional purchase method. The Commission has the ability to determine the appropriate accounting of generation capacity either as a purchase or an operating lease. This flexibility will allow the Commission the ability to disallow higher costs being passed on to Missouri ratepayers as a result of the current financial conditions affecting Aquila.

A. Aquila's Cost Allocation due to Changes in the Organization

In calendar year 2000, Aquila allocated $223,631,917 to its operating divisions and subsidiaries (business units). MPS was allocated $48,542,403 or 22% of the total corporate allocation. Aquila's corporate allocations consist of two groups both organized in specialized departments. The first group provides the traditional "shared service" or pure corporate overhead costs. Aquila refers to these departments as the enterprise support functions (ESFs). ESF costs are allocated to all of Aquila's domestic regulated and nonregulated business units. The other component of corporate allocations are groups that provide services (and incur costs) solely to Aquila's regulated utilities. Aquila refers to these departments as intra-business units (IBUs). These costs are allocated only to Aquila's regulated utilities.

Aquila has developed a comprehensive corporate overhead allocation procedure to allocate costs to its domestic business units. Aquila's primary method of allocating residual ESF and IBU costs is a three-factor formula referred to as the "Massachusetts Formula." Aquila uses the factors of gross profit (margin), net plant in service and payroll to calculate the relative allocation percentage for each business unit to apply to allocable corporate pool dollars.

The example below shows how Aquila allocates certain ESF costs to its domestic business units. Aquila's nonregulated merchant services weighted percentage of (margin + payroll + plant) to (total domestic business unit margin + payroll + plant) is 30.04%. Using an ESF department with $1,000,000, Aquila's Merchant Services business unit would be allocated $300,400 and MPS would be allocated $224,868, or 22.49 % of this cost. The allocation factors used in this example are the actual factors used by Aquila in its last rate case, Case No. ER-2001-672.

	Margin	Payroll	Plant	(Allocation Factor)
Merchant Services	$446,877	$50,065	$419,409	30.04%
MPS	$221,576	$24,845	$700,120	22.49%
Regulated Gas Ops	$260,069	$54,247	$573,409	27.55%
Pipeline Companies	$12,150	$584	$69,799	1.56%
Other Regulated Electric	$130,630	$17,991	$341,033	12.82%
Non-regulated	$21,251	$20,131	$58,488	5.55%
Total	1,092,553	$167,862	$2,162259	100%

In addition to the Massachusetts Formula, Aquila uses other allocation factors to allocate ESF and IBU department costs to its business units. For example, the ESF departments of 4220 (Compensation and Benefits) and 4223 (Human Resource Executive) are allocated based on the ratio of the number of employees in that business unit to the total number of all business unit employees. Also, ESF department 4140 (Risk Solutions) handles Aquila's insurance policies, including worker's compensation policies. The costs incurred during the year by this department are allocated based on the relative dollar amount of claims paid for each business unit.

Aquila's recent corporate reorganization, exit from the wholesale energy trading business, and $1 billion of asset sales could have a significant impact on the dollar amount of Corporate overhead costs allocated from Aquila to its Missouri regulated utilities of MPS and L&P. For example, while Aquila's corporate overhead costs will be reduced by the elimination of corporate employees, the remaining total corporate overhead costs to be allocated will have to be allocated over fewer business units. To illustrate, Aquila allocated approximately $30 million to its Merchant Services business in 2000. The wholesale energy trading business made up a majority of the Merchant Services business and this business has been terminated. The corporate overhead costs that were allocated to Merchant Services business will have to be allocated over a smaller entity with Aquila's regulated utility operations potentially being allocated significantly higher overhead costs.

The Staff has submitted several Data Requests to Aquila concerning corporate allocations and is in the process of evaluating and analyzing this information. The changes in the levels of these allocated costs, as well as the allocation factors themselves, could have significant impacts on the cost of service assigned by Aquila to its Missouri regulated operations.

B. Record Keeping and Affiliate Transactions

In Aquila's last rate case for its MPS operations, Case No. ER-2001-672, the Staff expressed some concerns with the manner in which Aquila was maintaining its books and records. This concern was addressed in the Unanimous Stipulation And Agreement reached by the parties to this case and approved by the Commission in February 2002. Item 13 of that

Unanimous Stipulation And Agreement listed specific reports that will be made available to the Staff. These reports are:

1. MPS and L&P division-specific ledgers on a Federal Energy Regulatory Commission ("FERC") account basis that include both direct and allocated costs by resource code;

2. MPS and L&P division-specific ledgers on a FERC account basis that reflect only direct charges to the divisions by resource code;

3. MPS and L&P division-specific ledgers on a FERC account basis that reflect only costs allocated to the divisions by resource code;

4. Plant and Depreciation Reserve ledgers for the MPS and L&P divisions that show beginning month balances, additions and retirements, and ending month balances;

5. Aquila Enterprise Support Function ("ESF") and InterAquila Business Unit ("IBU") department costs allocated to the MPS and L&P divisions on resource code basis; and

6. ESF and IBU department costs, by resource code, which are not subject to allocation to the MPS or L&P divisions.

The current financial difficulties being experienced and the corporate reorganization that is currently taking place at Aquila will put a burden on the record keeping commitments made to the Commission. The Staff contends that accurate, timely and complete record keeping by Aquila is essential for the Commission to effectively regulate MPS's and L&P's utility operations, especially in Aquila's current operating environment. The Staff will be monitoring Aquila's record keeping practices to determine if the requirements listed in the Unanimous Stipulation and Agreement are being reasonably satisfied.

In accordance with the Commission's affiliate transaction rules (4 CSR 240-20.015, 4 CSR 240-40.015, 4 CSR 240-40.016, 4 CSR 240-80.015), Aquila is required to provide its current Cost Allocation Manual (CAM) to the Commission Staff on or before March 15, 2003. To comply with Affiliate Transaction rules, the CAM should include the criteria, guidelines and procedures Aquila follows in allocating costs. The CAM should also describe the methods and basis Aquila uses to allocate corporate overhead costs to its individual business units. Aquila's current corporate reorganization should be substantially completed when the Staff receives Aquila's CAM in March 2003. If the CAM is in compliance with the rules, then it will provide information that will allow the Staff to have a better understanding of the impact of Aquila's corporate reorganization on its corporate allocations to MPS and L&P.

The Commission has ratemaking authority over Aquila's Missouri regulated operations. Aquila cannot legally raise the rates to these consumers without Commission approval. In this report, the Staff has begun identifying possible negative impacts on the Missouri regulated cost of service. The identification process serves as a checklist for the Commission, Staff and other interested parties to determine how these items are treated in future rate proceedings.

The Commission has the regulatory tools to address the inclusion or exclusion of the higher capital and interest costs from Aquila's cost of service to the extent the Commission so chooses. Hypothetical capital structures and adjustments provide the Commission the flexibility to address the higher capital and interest costs resulting from Aquila's non-regulated financial activity. Historically, the Commission has rarely used hypothetical capital structures and adjustments to estimate the cost of capital when setting rates of return. Hypotheticals and adjustments have been used only in unique situations, such as when the regulated entity does not issue its own capital or when the capital structure and cost of capital of the parent company issuing the capital is outside of what would be considered normal or typical for a regulated utility.

The current Aquila situation warrants consideration of the use of mechanisms to adjust the cost of capital for MPS and L&P future rate cases. This consideration is warranted to ensure

Aquila's higher cost of capital, due to its unregulated activities, does not increase the rates paid by the consumers of the regulated utility.

Specific examples of mechanisms that can be used to help prevent increased capital costs being passed on to MPS and SJLP ratepayers are: use of a hypothetical capital structure, adjustments to embedded costs of debt and preferred stock, adjustments to cost of equity estimates, use of comparable companies (to more closely reflect the cost of capital for a regulated utility versus a diversified energy company).

Section 4: Service Quality Overview

The ability of a utility to provide quality service to its customers is always an important concern for utility consumers and companies, as well as for the regulatory bodies that examine company activities. Aquila's current and future ability to provide quality customer service is of particular concern in light of Aquila's financial position and the significant organizational, operational and staffing changes that it has experienced. Uncertainty or change in financial, organizational or operational areas would be cause for increased concern about a company's ability to provide quality service, but this complex combination of circumstances and activities requires that increased focus be directed toward Aquila's customer service activities.

Recent events involving Aquila have created an environment conducive to diminished or reduced levels of customer service. Cost-cutting activities forced by a reduction in financial resources can manifest themselves in detrimental customer service staffing reductions, service order back-logs, delayed field work for service reconnections, reduced call-center responsiveness, poor billing practices. These are examples of practices that can directly impact customer service.

Staff has approached this investigation as a means of reviewing and evaluating key indicators of customer service with the intent of determining, to the extent possible, the level of service Aquila has been providing to its customers. It is important to clarify that while customer service indicators or measurements are valuable management tools and can lead to some conclusions regarding customer service, they cannot provide complete assurance that deficiencies are absent from its customer service activities. Such indicators serve an important role, but cannot replace a customer service review that more thoroughly analyzes and examines customer service processes and practices. A comprehensive customer service review of Aquila is planned for sometime in calendar year 2003, assuming the availability of Staff resources is not redirected to a greater priority.

Staff has requested a variety of current and historical information from Aquila to determine its performance regarding customer service. What follows in this section is a brief summary of the areas that Staff is reviewing for potential impact on customer service and the information Staff requested that could indicate negative trends in the customer service received by Aquila's customers. The areas of Staff's analysis that prompted any significant concerns are described more fully in Section 5.F. of this report.

It should be noted that this report does not address any issues with Aquila's planning or purchasing of natural gas supplies for its regulated Missouri utility customers. These concerns, as well as a number of related issues, are addressed in Actual Cost Adjustment (ACA) cases and have been the subject of a number of meetings between the Staff and Aquila.

A. Organizational Staffing

Staff requested information to assess specific organizational changes that have occurred within Aquila and its affiliates to determine if, based on these organizational changes, it appears that staffing levels to support Missouri's regulated operations have been reduced. Staff also asked for information regarding reductions in the total number of employees. Staffing reductions may be cause for concern relative to customers being subjected to a reduction in service quality. Section 5 of this report outlines a number of concerns with the information Staff has received regarding staffing levels that support electric transmission and distribution operations as well as call center support.

B. Customer Service Levels

Staff requested metrics in numerous areas to assess past trends in customer service levels and to determine if any changes have recently occurred or are currently planned to occur in the near future. Reduced levels of service in a number of areas (i.e., call center response times, gas safety-related responses and check intervals, or electric service quality parameters) will prompt further expedited review of Aquila's operations. Section 5 includes considerable discussion on issues related to Aquila's complaint trends, employee turnover, customer service work orders, and call center operations.

The total number of customers served by Aquila is shown in the table below. The numbers include Aquila's total number amount of Missouri gas and electric customers 2001 and the total gas and electric customers of St. Joseph Light and Power Company.

Total Number of Customers Served by Aquila					
Year	1997	1998	1999	2000	2001
Number of Customers	305,368	311,201	320,769	324,088	326,429
Percentage Increase		1.91%	3.07%	1.03%	.72%

Source: Missouri Public Service Commission's Annual Reports

C. Aquila's Response to Reduction in Service Quality

Aquila's responses and/or plans for responses to changes in its quality of service are as important as what quality assurance monitoring Aquila has already performed. Staff requested information to determine specific quality assurance programs Aquila has put in place to assure that service quality levels are not degraded as a result of their reorganization. Section 6 of this report describes the responses that Aquila provided to Staff's Data Requests in this area and any Staff concerns with these responses.

D. Electric Generation Plant

Maintenance of generation plants is necessary to maintain or extend the life of a power plant and to maintain or increase the efficiencies of the plants. Maintenance may be delayed because of an emergency in other resources, to reduce maintenance expenditures or to sell more energy on the spot market. Any delay in maintenance could result in more forced outages which could lead to outages at customers' premises. Forced outages are not planned and typically occur when there is an equipment failure at a generation plant not only due to lack of maintenance, but also due to the age of the plant or an accident. Even if there is not a reduction in quality of energy provided, the delaying of maintenance could result in an increase in costs for generation plants in the future. This will be examined in any future rate cases. Staff reviewed both an eight-year history of outages and the maintenance outage schedule for the next five years for each of the MPS and L&P generation plants along with the projected budget for each plant for the next five years. Section 7 of this report describes the responses that Aquila provided to Staff's Data Requests in this area and any Staff concerns with these responses.

E. Electric Transmission and Distribution

Transmission and distribution equipment are vital to the delivery of reliable power to Aquila's electric customers. Staff reviewed Aquila's transmission and distribution maintenance and construction expenditures and staffing along with tree trimming expenditures for the previous five years and the next year's projected expenditures, for any trends that might indicate a reduction in transmission and distribution service to Aquila's customers. Staff's review of the information provided thus far concluded that tree trimming expenditures for MPS and L&P appear to be relatively stable or increasing. Also, new electric transmission expenditures for MPS have been stable or increasing in recent years but Staff notes that L&P data was incomplete. Staff's review of expenditures for maintenance, construction, and operations were also reviewed. The trends from this review are provided in Section 5 of this report.

F. Electric Resource Planning

One area that a current reduction in the availability of capital could impact is resource planning. Aquila will need more capacity in the near future when its current contract for power from the Aries plant expires. Aquila will also need additional capacity to meet load growth. Staff continues to meet with Aquila on an on-going basis to discuss its resource plans. The most recent meeting was held on November 26, 2002. In addition to these meetings, Staff requested and reviewed information regarding generation construction and budgeted expenditures. Staff also reviewed Aquila's purchased power sales and purchases over the past five years. An increased reliance on purchased power either through a fixed, pre-determined contract or spot market purchases could indicate that Aquila is exposing itself, and eventually its customers, to the risks of the wholesale market. Sections 6 and 7 of this report describes the responses that Aquila provided to Staff's Data Requests in this area and any Staff concerns with these responses.

Section 5: Service Quality Concerns

A. Organizational Staffing

In response to a Staff Data Request, Aquila provided information on staffing and expenditures to support numerous aspects of Aquila's regulated businesses. Some of the information provided was supportive of a continued level of service quality and appropriate support of plant equipment. Some information shows a need for continued Staff monitoring. Other information has resulted in additional Data Requests being sent to Aquila and will be subject to further discussion with Aquila.

One area of concern to Staff is an apparent reduction in call center staffing. From 1998 to 2002, the number of Call Center full-time equivalents (FTEs) has experienced considerable fluctuation. Aquila utilized three call centers during years 1998 through 2001. In 2002, it reduced the number of call centers to two. Call Centers are presently located in Raytown, Missouri and in Lincoln, Nebraska. Aquila provided the following Call Center FTE data for 1998 through 2002:

1998	(3 centers)	175.5 FTEs
1999	(3 centers)	193.20 FTEs
2000	(3 centers)	187.90 FTEs
2001	(3 centers)	222.41 FTEs
2002	(2 centers)	143.00 FTEs

Aquila indicated that its implementation of an interactive voice response (IVR) system during 2001 allowed it to close a call center in Monroe, Michigan and reduce call center staff by approximately 35 FTEs. Aquila indicates that the IVR system allows a certain percentage of its customers to seek/receive self-service. In addition to this change in operations, Aquila states that several of non-call center related functions that were being handled by the call center are now being addressed through the customers' use of the IVR. Aquila believes these changes made it possible to reduce call center staffing without a reduction in service quality. Staff's findings on call center service quality are addressed in subsection B of this section of the report. As presented in that section, call center performance indicators demonstrate a sharp spike in the Average Speed of Answer (ASA) and Abandoned Call Rate (ACR) for the months April, June, July and August 2002.

Another area of concern is an observed reduction in staffing for electric transmission and distribution support. After 2000, L&P transmission and distribution support dropped significantly. It is expected that some staffing changes would have occurred following the merger but the level of reductions created concern. Also, the reduction in staffing at L&P was not offset by an increase in staffing at MPS. In fact, MPS also experienced a significant reduction in electric transmission and distribution staffing following the merger. Staff is checking further to see if some of these transmission and distribution reductions were compensated for with contract labor.

Generation plant staff was constant from 1998 through 2000. In 2001, the first year after the merger, generation plant staff declined by approximately 3%. In 2002, plant staffing decreased by one person. Staff will continue to monitor generation plant staff and will report anything that raises concerns.

The Staff is thoroughly reviewing other metrics used to assess if Aquila is maintaining its system and generation plants adequately. Electric system outage duration and frequency metrics as well as plant outage information are being used in this evaluation.

B. Customer Service Level

As noted in Section 5, Aquila's complaint trends, employee turnover, customer service work orders, and call center operation trends have been identified as areas of interest to describe in this section of Staff's report. Staff will continue to monitor this area through the review of the responses to outstanding Data Requests as they are provided by Aquila.

C. Commission Complaint Trends

Aquila's Missouri Public Service Commission complaints are trending upward. The Missouri Public Service Commission's Consumer Services Department reports the following numbers of Commission complaints for Aquila (gas and electric) from 1999 to 2002. These numbers include the number of complaints regarding St. Joseph Light & Power Company prior to the merger that occurred in 2001.

Year	1999	2000	2001*	2002**
Complaints	97	146	287	224

Source: Missouri Public Service Commission's Consumer Services Department

*Company filed for a rate increase during this year which may have impacted the number of customer complaints.
**Complaint numbers are through October 2002.

As demonstrated above, Commission complaints increased significantly from the year 2000 to year 2001. The 287 complaints in 2001 represent almost a 100% increase from the previous year, 2000 and an approximate 195% increase from 1999. While year-to-date, 2002 Commission complaints are currently lower than year-end 2001, they are nonetheless approximately 54% higher than 2000 and approximately 130% higher than 1999. This significant increase and rising trend in Commission complaints is an indication of customer concern or dissatisfaction with Aquila. Aquila's rate cases may have increased customer contact with the Commission Staff, but the upward trends are significant regardless. The ice storm that occurred in January of 2002 also impacted customer complaint numbers.

D. Employee Turnover Rate

As part of its investigation, Staff requested Aquila's turnover rates of employees dedicated 100% to customer services for natural gas and 100% to customer services for electric for MPS and L&P for the period September 1997 through September 2002. In its response, Aquila stated that monthly turnover rates for employees by customer services for electric for MPS and L&P were not available.

The monitoring of Aquila's employee turnover rate is an important and effective management tool. Employees are one of a company's greatest resources and the tracking of its turnover rate and monitoring of the reasons employees leave Aquila are imperative. Unless the turnover rate is continuously monitored, Aquila is unaware of the current trend and whether the rate is increasing or decreasing. Without this data, Aquila is unable to measure the effectiveness of implemented policy changes or strategies in relation to its employee turnover rate. The tracking of Aquila's employee turnover rate would provide Aquila with valuable information, i.e., justification for hiring additional personnel and an expected time when employees have completed training and are able to work independently. High turnover rates may be indicative of a less experienced staff and lower job productivity because of additional training requirements and other management considerations.

Staff believes that the possibility exists for customer service quality to decline when a company's employee turnover rate is high. Some of the other possible effects of a high employee turnover rate include replacement of valuable knowledge and possible decline in employee morale.

E. Customer Service Work Orders

Through a Staff Data Request, Staff asked Aquila to provide the number of customer service work orders not completed by month-end, the percentage of customer service work orders not completed by month-end and provide an explanation of any increasing trends. In addition, the Staff requested Aquila to provide any reports that monitor the timeliness of the completion of customer service work orders and to explain any changes or trends.

In its response to Staff's Data Request, Aquila stated that it does not maintain historical tracking of completed service orders at month-end. Aquila also stated in its response to the Data Request response that it has no formal report to track the timeliness of service order completion.

Although Aquila reviews at the end of each workday the service orders not completed and determines the method to complete those service orders, Aquila does not maintain a tracking system of the customer service work orders. Therefore, Aquila is not able to determine whether or not service orders are completed as requested by the customer. In addition, Aquila is not able to determine whether or not 'reconnect for delinquent disconnect service orders' are being completed on the day restoration is requested by the customer, the next working day following the day requested by the customer or on a day following the next day after the request. If Aquila is not tracking the completion of its service orders, it is unable to determine whether or not it is adhering to the Commission's Chapter 13 Billing and Services Practices Rule.

The tracking and documentation of the completion of service orders would serve the Company as a valuable and effective management tool. Aquila would be aware of the effectiveness and efficiency of its personnel. From this documentation, Aquila would also be able to determine any necessary changes to its level of personnel or changes to its techniques or strategies to complete the work process.

In Data Request No. 3906 the Staff requested any documentation Aquila maintains that monitors the activity of the completion of customer service work orders, i.e., average amount of time to complete connect service work order. Aquila's response stated that it uses a Computer

Automated Dispatching (CAD) system to monitor, throughout the day, the status of its service orders. This is real time information. However, this information does not monitor the activity of the completion of work orders continuously. Documentation that monitors the activity of the completion of customer service work orders would serve as an important management tool. This information would assist management in the scheduling of_customer service work orders, i.e., number of customer service work orders that can be performed during a workday. In addition, management would be able to use this documentation to monitor its personnel and determine necessary changes to staffing levels.

F. Performance Measures

In a Staff Data Request, Aquila was asked to provide its Call Center Average Speed of Answer (ASA). The calculation for Aquila's ASA is determined by dividing the total seconds to answer the calls Aquila responds to by the number of calls answered. Aquila's abandoned calls are not included in this calculation. Aquila uses a virtual call routing system to dispatch calls based on the subject matter identified in the initial screening process. The calls are then routed to the first available agent in Raytown, Missouri, or Lincoln, Nebraska, based upon the available agents' approved skillset(s). Aquila indicates that the link between Raytown and Lincoln is seamless. Aquila's response to Data Request No. 2904 is shown in the table below:

Average Speed of Answer 1998-2002												
	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
1998			29	48	47	56	65	53	61	90	46	33
1999	64	69	60	42	58	88	75	64	108	108	58	51
2000	22	18	37	33	57	41	61	43	84	69	72	79
2001	56	19	15	37	67	54	44	36	123	81	26	12
2002	46	40	19	87	63	160	154	108	72	82		

Aquila also noted in its response that beginning in 2001, in addition to the ASA it has been tracking, it now tracks the ASA for emergency calls separately. For 2001, Aquila reported that its ASA for emergency calls was 9 seconds. For the nine months of 2002, its ASA for emergency calls was 24 seconds.

In its response, Aquila states that its yearly ASA average is 53, 71 and 52 for 1998, 1999 and 2000, respectively. But, Aquila's ASA range for 1998 is 29 seconds to 90 seconds, for 1999 is 42 seconds to 108 seconds and for 2000 is 18 seconds to 84 seconds.

Staff notes that Aquila's yearly ASA average increased approximately 34% from 1998 to 1999. But, Aquila's 2000 yearly ASA average returned to one second less than its 1998 yearly ASA average. While the yearly average is significant, review of monthly data is important where peaks can be more easily identified.

The ASA chart clearly demonstrates that for the ten months of 2002 reporting, the ASA has increased from the previous year for seven of the ten months. When comparing the ASA seconds for 2001 to 2000, an increase occurred six of the twelve months. The Staff noticed an improvement in the ASA for the year 2000 when compared to the year 1999. For ten months of 1999, the average speed of answer was greater than 2000. For the months of June, July and August 2002, the Staff noticed a dramatic increase when compared to the same months for the four previous years averages.

Aquila was also asked to provide its Call Center Abandoned Call Rate (ACR). The calculation for Aquila's ACR, which is the percentage of total calls offered that are abandoned before answered by Aquila, is determined by dividing the total number of abandoned calls by the total number of calls offered. Aquila's response is shown in the table below:

Average Abandoned Call Rate												
	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
1998		5.69	4.55	6.95	6.72	8.47	8.50	6.50	7.19	9.64	5.85	4.58
1999	7.7	7.52	7.69	6.12	7.9	10.55	9.06	7.21	11.16	11.11	6.62	5.76
2000	2.49	2.18	4.74	3.90	6.68	4.74	6.87	4.63	9.3	7.55	7.53	8.72
2001	5.3	1.9	1.7	4.2	7.4	6.0	4.7	4.0	11.2	7.6	2.7	1.2
2002	6.2	4.7	2.0	11.3	7.7	19.4	17.5	11.7	7.2	8.5		

Aquila's ACR averages for 2002 were greater than its 2001 averages for nine of the ten months reported. For the months of June, July and August for the year 2002, the Staff noticed a significant increase when compared to the same months for the four previous years averages.

G. Estimated Bills

The Staff requested the five-year monthly history through September 2002 of the number of estimated bills per month. Aquila's responses to Data Request Nos. 2902 and 3909 are displayed in the table below:

Aquila's Bill Estimates					
Year	1998	1999	2000	2001	2002 (Jan. – Sept.
Total Number	90,001	162,367	178,894	128,776	68,055

The Staff observed that the number of bill estimates increased 80% from 1998 to 1999 and 10% from 1999 to 2000. Aquila's estimated bills declined from 2000 to 2001 and a decline is anticipated from 2001 to 2002.

In addition to the customer service issues described above, Staff reviewed a number of electric reliability/service quality related indices. These service quality indices included the following:

- SAIDI – System Average Interruption Duration Index
- SAIFI – System Average Interruption Frequency Index
- CAIDI – Customer Average Interruption Duration Index (SAIDI/SAIFI)
- MAIFI – Momentary Average Interruption Frequency Index

Review of Aquila's values for their MPS and L&P systems showed a number of trends. Aquila's MPS system has historically experienced a significantly higher incidence of momentary outages (MAIFI) than its L&P system. Staff is reviewing this trend in an effort to identify what factors are specifically contributing to this problem. Aquila's L&P system's MAIFI was relatively low in the two years of data that were available. While MPS was not as reliable as L&P in one area it was L&P that in fact had a higher average interruption frequency (SAIFI) than MPS, this is another area of further Staff inquiry. Outage durations (SAIDI) were somewhat higher for MPS vs. L&P. Overall, Staff did not notice any significant trends in degradation of indices in the six years of data reviewed.

H. Gas Safety

An important aspect of Staff's review of Aquila's service quality was how Aquila was performing its gas safety related functions that are regulated and monitored by the Commission. The Commission's gas safety Staff conducts inspections on all operators approximately annually regarding their compliance with Commission rules. Several different gas safety Staff have been involved in these inspections of Aquila. In general, Staff did not find any significant deficiencies with Aquila's gas safety program in its review. Staff's gas safety reviews of the entities that fall under Commission jurisdiction are an ongoing effort. The Aquila Inspection Units were/are scheduled to be inspected as follows:

Aquila Inspections Units	**MoPSC Inspection Date**
1. Sedalia Area	April 2002
2. Rolla/Salem Area	April 2002
3. Platte City Area	June 2002
4. Maryville Area	August 2002
5. Nevada Area	September 2002
6. Marshall Area	September 2002
7. Chillicothe/Trenton Area	November 2002
8. Lexington Area	November 2002
9. Clinton Area	December 2002 (Scheduled)

MPS initiated and began a cast iron and bare steel main replacement program before a Commission 1989 Rule required those replacements, so they are well ahead of the other natural gas operators in this area. Aquila has replaced its unprotected steel service lines and only has a few yard lines remaining. Aquila is on-track with those replacements. Due to these early replacements and replacements required by the Commission regulations, Aquila's maintenance efforts now are greatly reduced. Staff's review of gas safety items included, but was not limited to, the following:

Gas Safety Item	Status
Leak Response Times	OK (*with a small issue that is likely resolved at this point*)
Leak Survey Intervals	OK
Cathodic Protection	OK (*with an issue being resolved*)
Regulation Station Inspections	OK
Leak Rechecks	OK
Essential Valves	OK
Replacement Programs	OK

There are always "issues" contained in the Inspection Summaries, but Staff's review did not determine anything "out of the ordinary" with Aquila's inspection units. Since Staff performs on-site work at Aquila at least nine different times per year, spread throughout the year, Staff believes that it should be able to identify potential problems as they arise.

Another important area of Staff's review of Aquila's customer service was the reliability of its electric delivery system. Staff received, through Data Requests, electric system interruption, frequency and duration information. The items of interest from this review are described in Section 6.

Section 6: Aquila's Response to Reduction in Service Quality Concerns

Staff requested information to determine what quality assurance programs Aquila has put in place to assure that service quality levels are not degraded as a result of its reorganization. These Data Requests explore whether or not any service quality metrics are being reviewed by Aquila, if any reductions in service quality have been observed, and what Aquila will do if any reductions in service quality are observed in the future.

The first of Staff's Data Requests in this area asked if Aquila had put in place any monitoring to assure no reduction in customer service quality (as determined by the metrics in Data Request No. 2904). Aquila responded to this data request with the following:

Natural Gas and Electric

- Call Center Average Speed of Answer
- Call Center Abandoned Call Rate

> Since 1999, Aquila has contracted with the Gallup Organization to complete a monthly customer service survey across three separate categories—"Billing & Image", "Customer Connect" and "Payment Arrangement". These three areas represent the largest areas of customer contact within our organization. Each month a portion of the customer base is surveyed by Gallup to provide results at a 90% confidence level from the responses. The results are then tabulated and scored on a 0-100% scale. Customers having contact with Aquila in the past 30 days pertaining to "Customer Connect" or "Payment Arrangements" are provided in the monthly samples. To obtain a sample for the "Billing & Image" portion, a general sample of our complete customer base is used. This year we have upgraded the process by increasing the sample size and improving the number and types of questions asked. Reports on the three separate areas are compiled and an overall composite score for customer service is determined.

Natural Gas

- Leak Response Times (call received to service man arrival)
- Leak Survey Intervals
- Cathodic Protection Survey Intervals
- Regulator Station Check Intervals
- Rechecks for Classified Leaks Intervals
- Essential Valve Recheck Intervals
- Keeping Current with Pipeline Replacement Programs

Aquila continually monitors to ensure that natural gas service quality is in compliance with or exceeds regulations. All leak responses have historically been documented on forms relating to each individual leak response. These documents are filed in our operating areas and reviewed annually by the Gas Safety Staff of the Commission for compliance with State regulations. Instances in which our response to a gas leak has been found deficient are few in comparison to the total number of responses we make annually. We are implementing a more automated process of summarizing our gas leak response but the system is not fully integrated with our field reports at this time.

The definitions, procedures and intervals pertaining to all mandated leak surveys, cathodic protection monitoring, gas leak classification/monitoring and essential valve maintenance are clearly presented in the State regulations. Our compliance with these regulations is monitored during annual inspections by the Gas Safety Staff of the Commission. All nine of our operating areas are inspected. No major concern regarding our compliance with any of these procedures has been noted during the inspections. The documentation pertaining to these mandated functions is extensive and retained in the individual operating areas.

All mandated pipeline replacement programs were completed well in advance of the scheduled completion dates. Our program was completed in the early 1990's. Our "yardline" replacement program is still in progress and is scheduled for completion in 2005. A summary of the status of this program is submitted annually to the Gas Safety Staff of the Commission.

SAIDI, SAIFI, CAIDI, CAIFI, MAIFI

Aquila has for years monitored performance on these metrics. Reports are reviewed by operations management each month and periodic reports are filed with the state.

Staff's review of this response is generally consistent with information Staff has received through discussions with Aquila and Staff that work with Aquila on some of these issues (i.e., Gas Safety). Staff's review of the data described in Data Request No. 2904 is provided in previous subsections of this section of the report.

Staff's second Data Request in this area asked if Aquila had observed any reductions in service quality metrics (in Data Request No. 2904) and if any management actions had been taken to restore or increase service quality. Aquila responded to this data request with the following:

> After reviewing the response to Data Request MPSC-2904, we do not believe that the information provided denotes any deterioration in service quality over that timeframe.

Staff does not necessarily share Aquila's view of the data provided in response to Data Request No. 2904. This section of the report describes several observations from Staff's review of provided data that have resulted in further inquiries by Staff. The third and last of Staff's Data Requests in this area asked what Aquila will do in the future if any service quality (Data Request No. 2904) changes are observed. Aquila responded to this data request with the following:

> Aquila strives to match a healthy balance of safety, customer service and reliability performance against the cost of achieving that performance. Management would typically focus to a greater extent on significant declines in performance. To the extent that significant declines are noted in any of the metrics described in Data Request No. 2904, management would endeavor to determine the root cause of any such decline, identify measures that could be taken to reverse the decline, analyze the cost to customers of implementing a solution and reaffirm an appropriate baseline for performance. Then management would develop and carry out an action plan designed to re-establish that baseline of performance. The determination of what is significant and the action plan to bring about acceptable performance would, of course, be situationally dependent.
>
> It should be noted that management typically would not wait until performance has declined "significantly" below our standards before addressing issues. For example, our call center performance statistics have not significantly declined but in recent months there has been a level of deterioration in some aspects of the call center's performance metrics. That decline has been identified as occurring due to a combination of internal promotions of experienced call center employees within Aquila shortly before we began experiencing a level of calls greater than we had historically experienced. In order to maintain our baseline performance, Aquila has implemented an action plan to aggressively hire new personnel for the call center and to increase the quality and availability of training programs to all impacted employees.

Through a number of meetings that Staff has held with Aquila and information that has been received through Data Requests, Staff has collected a significant amount of information to monitor several aspects of the service quality that Aquila is providing its customers. The information collected thus far, and information planned to be collected, will provide Staff with the opportunity to review several aspects of Aquila's efforts to maintain or improve its service quality level to its customers. Aquila's success at addressing any future downward trends in service quality will be an item of interest in Staff's ongoing discussions with Aquila.

Section 7: Other Staff Concerns

A. Electric Generation Plant Concerns

At the time of this report, Staff had not had time to conduct a complete review of Aquila's historical and projected outage and purchase power data. Staff will complete its review and continue to monitor this area until such effort is no longer required. Staff will determine if additional action is necessary as dictated by the facts and conditions of the concern.

Staff's initial review of the historical forced and maintenance outage hours was conducted on both a unit-by-unit basis and for the total system. The forced outage rates are very sporadic and do not demonstrate any marked trend. However, projected outage schedules show a lower level of scheduled outages averaged over the next four years than has been averaged over the past eight. Staff believes that shorter outages are an industry trend that needs to be monitored to ensure that forced outage rates do not increase.

The purchase power data reviewed thus far indicates that Aquila has spent less on generation in the last year and more on purchased power as expected since MPS's current contract with the Aries plant is included in this data. However, Aquila's future reliance on purchase power was a point of discussion in Staff's Integrated Resource Planning meeting with Aquila. The L&P expenditure trends are related to maintenance, construction or operations support beyond the recent reduction in generation and the recent increase in purchased power at MPS. These trends are either scattered or relatively stable.

B. Electric Transmission and Distribution Concerns

Staff's review of maintenance, construction, and operations expenditures yielded a number of trends that Staff will be discussing with Aquila in the near future. Staff notes that Aquila's new electric transmission expenditures data for L&P was incomplete.

At the time of writing this report, Staff had not had adequate time to review the information to provide an assessment. Staff met with Aquila regarding this issue on November 26th and is carefully reviewing the information collected in that meeting. Staff will continue to review this area in the future.

Section 8: Aquila Investigations Activity in other States

A. Kansas

On March 11, 2002, the Kansas Corporation Commission issued an Order Initiating Investigation into the standards and criteria for affiliate transactions involving the regulated utility businesses and the unregulated businesses of Aquila. The Order specified that the investigation was necessary with the then recent downgrade of Aquila's debt rating by Fitch, which according to the Order was attributed by Fitch, in part, to Aquila's unregulated businesses. The Order further specified that the purpose of the investigation was to better understand how Aquila will meet its statutory obligation to serve its utility customers in light of its impetus for diversification into unregulated business activities. The Order stated that the investigation would assess the impact of and risks of Aquila's unregulated business activities on its Kansas electric and natural gas regulated business. The Order further specified that the investigation would determine whether any guidelines or criteria should be established about the relationship between the regulated business and the unregulated activities.

As mandated by the Order, Aquila filed its report on June 14, 2002, as a confidential report. The Staff of the Kansas Corporation Commission (KCC Staff) filed its report on October 31, 2002 (Appendix A). The KCC Staff made several initial recommendations. The KCC Staff noted that the organizational structure of Aquila is constantly changing. The KCC Staff opined that the organization of utility businesses along state jurisdictional lines has merit from an accounting and financial perspective. The KCC Staff noted that Aquila's CCAM needs further revision to assure that corporate common costs are being properly assigned and allocated to the regulated utilities and the non-regulated affiliates. The KCC Staff further stated that the

Code of Business Conduct will need to be revised as the business environment dictates. The KCC Staff further recommended that an Affiliates Transactions Policy and Procedures Manual would be of great value.

The KCC Staff also requested that Aquila provide updates on its closure of Aquila Merchant Services' trading positions, associated liabilities and Aquila's general financial health. These updates were to be provided to coincide with the publication of Aquila's financial statements.

Another case of interest in Kansas is Docket No. 01-WSRE-949-GIE (Appendix B). This is an investigation of whether Western Resources, Inc. (WRI) must be required to separate its jurisdictional electric utility business from its unregulated businesses. On May 8, 2001, the Kansas Corporation Commission initiated this investigation. On July 20, 2001, the KCC determined WRI's participation in certain restructuring transaction were not consistent with the public interest and violated Kansas law. The KCC prohibited the transactions. The Order further required WRI to submit a financial plan to restore WRI to financial health, to achieve a balanced capital structure and to protect ratepayers from the risks of nonutility investments.

On January 8, 2002, the KCC expanded its inquiry to assess the impact of and risks associated with WRI's interest in or affiliations with nonutility business activities on WRI's jurisdictional electric utility business.

WRI's Financial Plan was rejected by the KCC because the KCC found that it compounded rather than addressed WRI's underlying problems. The KCC had concerns about steps that WRI had taken to subsidize and enrich its nonutility business and investments to the detriment of the electric utility and its ratepayers. The KCC determined that in order to address these concerns, there must be proper identification of costs and investments attributable to regulated utility and nonutility activities and allocation of common costs and investments between them. The KCC set out a specific plan and steps to be taken by WRI to address the concerns and order WRI to refrain from taking any action that results in a direct or indirect subsidization of nonutility business activities by regulated utilities.

B. Minnesota

In August of 2002, the Minnesota Public Utilities Commission began inquiries into utilities under its jurisdiction that have financial difficulties. The inquiries of which this Staff is aware are directed to QWEST Corporation Inc., Northern States Power Company d/b/a Xcel Energy, and Aquila, Inc., which operates in Minnesota as Peoples Natural Gas & Northern Minnesota Utilities. While Xcel Energy may have more extensive operations in Minnesota, because Aquila, Inc. also operates in Missouri, the Staff has monitored the activities in the docket the Minnesota Commission established for its inquiry into Peoples Natural Gas & Northern Minnesota Utilities.

On August 16, 2002, the Minnesota Public Utilities Commission (MPUC) issued a Notice that it would consider whether any action should be taken regarding an inquiry into Possible Effects of the Financial Difficulties at Aquila, Inc. on it operating companies in Minnesota. The relevant companies in Minnesota are Peoples Natural Gas Aquila and Northern Minnesota Utilities Aquila.

In an Order issued on September 4, 2002, the MPUC determined that an inquiry was appropriate and ordered Aquila to file written responses to certain questions from the Commission within 15 days. Aquila filed its Compliance Filing on September 18, 2002 (Appendix C).

In its Compliance Filing, Aquila answered the questions on corporate structure, finance and related issues propounded by the MPUC. Aquila explained that its business focus shifted from a balanced strategy of merchant and global networks to a strategy of operating an integrated utility and a portfolio of non-regulated merchant generation. Its U.S. Network business orientation changed from a centralized utility structure organized around the concept of unbundled services to each operating division to a state-focused, integrated utility concept. Aquila also provided a general description of its current organization of corporate financing for Aquila, its subsidiaries and divisions. Aquila provided information on its financial situation. Aquila also responded to a question about its risks and potential liabilities in regard to Aquila Merchant Services, any other division or subsidiary as part of the SEC energy trading investigation, FERC investigation and any other lawsuits or similar issues. Aquila also responded regarding protection of Minnesota ratepayers.

Various entities also filed comments on this matter, which are attached to this report as Appendices D through F. These entities were the Attorney General of Minnesota, Aquila and Minnesota Department of Commerce.

Section 9: Possible Issues Raised in the Event Aquila Files for Bankruptcy

A. Chapter 11 Reorganization

Aquila is an "electrical corporation," a "gas corporation" and a public utility as those terms are defined in Section 386.020, RSMo 2000, and is subject to the jurisdiction of the Commission pursuant to Section 386.250, RSMo 2000.

As the Commission stated in its Report And Order entered December 14, 2000 in Case No. EM-2000-292 (*In the Matter of the Joint Application of UtiliCorp United Inc. and St. Joseph Light & Power Company for Authority to Merge St. Joseph Light & Power Company with and into UtiliCorp United Inc., and, in Connection Therewith, Certain Other Related Transactions*), the Commission is:

> statutory[ily] obligat[ed] to provide continuous regulation of the public utilities of this state. In describing the authority and responsibility of the Public Service Commission, the Missouri Supreme Court has stated that the Commission is:
>
> a fact finding body, exclusively entrusted and charged by the legislature to deal with and determine the specialized problems arising out of the operation of public utilities. . . . Its supervision of the public utilities of this state is a continuing one and its orders and directives with regard to any phase of the operation of any utility are always subject to change to meet changing conditions, as the commission, in its discretion, may deem to be in the public interest. *State ex rel. Chicago, R. I. & P. R. Co. v. Public Service Commission*, 312 S.W.2d 791, 796 (Mo. 1958).

In rejecting a proposed stipulation and agreement that would have limited the Commission's ability to entertain complaints against a Missouri utility, the Commission stated as follows:

> The Commission cannot agree to relinquish it statutory duties as proposed by the parties. The Commission is essentially a creation of the Legislature and, as such, is empowered by statute to carry out certain functions. Among the various statutory responsibilities incumbent on the Commission to perform are the setting of rates (Section 393.150, RSMo), the provision of safe and adequate service

> (Section 393.130, RSMo), the proper litigation of complaints (Section 386.400, RSMo) and other general powers (Section 393.150). The Commission cannot proceed in a manner contrary to the terms of a statute and may not follow a practice which results in nullifying the express will of the Legislature. Public Counsel v. Missouri Gas Energy 6 Mo. P.S.C. 3d 464, 465 (1997).

While made in the context of reviewing a stipulation and agreement, the statements above regarding the Commission's duties and obligations are of general applicability. Thus, regardless of Aquila's nonregulated activities, the Commission has both the authority and duty under Missouri law to set utility rates, assure the provision of safe and adequate service and to oversee Aquila's regulated activities.

Although the Commission has authority under Missouri law to regulate Aquila, the issue of federal preemption would arise if Aquila were to seek relief under the federal bankruptcy code. The Staff does not perceive Aquila to be in such financial distress that a bankruptcy is imminent, but the Staff would consider itself remiss if it did not address the issue. Although not experts in bankruptcy law, it is the Staff's understanding that, in the event Aquila were to file for reorganization under Chapter 11, the Commission would only retain exclusive jurisdiction over ratemaking. Title 11 Section 1129(a)(6), in part, provides:

> The court shall confirm a plan only if all of the following requirements are met:
>
> * * * *
>
> (6) Any governmental regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such approval.

Thus, if the reorganization were to entail the transfer of generating plants or other assets, it appears that the bankruptcy court could allow those transfers to take place without any review by this Commission. The Staff believes it is likely that a bankruptcy court would exercise its discretion and allow one or more Commissions in affected states to conduct a review of any such transfer but, ultimately, by virtue of federal preemption, the bankruptcy court would have the final say on allowing the transfer to occur. Both the Minnesota Attorney General's Office and Aquila addressed this issue in detail in comments filed with the Public Utilities Commission of Minnesota in that Commission's Docket No. G007, 011/CI-002-1369 (Appendices E and F to this report). It is noteworthy that, unlike the public utilities this Commission regulates, when a railroad is reorganized under Chapter 11, Congress expressly requires that both the trustee and bankruptcy court consider the public interest (11 U.S.C. § 1165) and that:

> [e]xcept with respect to abandonment under section 1170 of this title [11], or merger, modification of the financial structure of the debtor, or issuance or sale of securities under a plan, the trustee and the debtor are subject to the provisions of subtitle IV of title 49 that are applicable to railroads, and the trustee is subject to orders of any Federal, State, or local regulatory body to the same extent as the debtor would be if a petition commencing the case under this chapter had not been filed, but –
>
> (1) any such order that would require the expenditure, or the incurring of an obligation for the expenditure, of money from the estate is not effective unless approved by the court; and
>
> (2) the provisions of this chapter are subject to section 601(b) of the Regional Rail Reorganization Act of 1973. (11 U.S.C. § 1166).

B. Chapter 7 Liquidation

The Staff has also reviewed Chapter 7 of the federal bankruptcy code, which provides for liquidation of a bankrupt. The Staff notes that the trustee in a Chapter 7 bankruptcy is, among other things, charged with "collect[ing] and reduc[ing] to money the property of the estate for which such trustee serves, and clos[ing] [the] estate as expeditiously as is compatible with the best interests of parties in interest." 11 U.S.C. § 704(1), but finds no provision that requires consideration of the public interest or any deference to state bodies that regulate the types of utilities that fall within this Commission's jurisdiction. Thus, it appears that any role this Commission might have in the liquidation of a bankrupt's estate would be limited to that which the bankruptcy court chooses to allow.

Aquila

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Response to Missouri Public Service Commission' Staff Report on Aquila, Inc.

Aquila, Inc. appreciates the opportunity to review and comment on the "Staff Report on Aquila, Inc." dated December 2002 and presented to the Missouri Public Service Commission. We commend the Staff on a thorough review and factual presentation, performed in a relatively short period of time. We agree with the Staff's comments that Aquila is one of many energy companies whose financial condition suffered following Enron's collapse and the general destabilization of the energy industry. The recent joint statement released on November 13,2002 by NARUC and EEI recognized the unprecedented change when they stated: "The electric power industry is now facing a financial crisis perhaps more acute than any in its modern history with the loss of billions of dollars in market capitalization among investor-owned electric companies. This financial distress is not occurring in isolation, but rather reflects broader market conditions and investor attitudes." Aquila also understands and accepts the responsibility for Staff's concerns that the resulting impacts, if not properly managed, could negatively impact safety, quality of service and other performance areas.

Aquila wants to assure the Commission, its Staff, and our customers that we are fully committed to effectively manage this transition and to maintain service quality, reliability, and safety. We agree with the Staff's statement that the Missouri Public Service Commission maintains substantial authority to monitor performance and protect customers from inappropriate rate increases. We are well aware of the increased outside scrutiny that exists as a result of our current financial situation, and have, in fact, increased our own focus on customer service. The performance metrics that have always guided our utility operations are still in place, monitored regularly, and action plans initiated to address any identified problems.

While we applaud the Staff on a complete and factual report, we believe that the understanding of some areas of concern would benefit through additional comment or information that may not have been available to the Staff at the time of their report preparation. In presenting this information, it is not our intention to criticize the Report presented, but instead to acknowledge our joint concern and further clarify our positions and ongoing efforts. In that regard, Aquila offers the following comments:

1. In various sections of the Report, concerns are raised regarding the implications on performance of reducing utility Staff personnel. The Report correctly cites the elimination of approximately 500 positions from our Networks business. However, it should be noted that the planning for these 430 utility and 80 corporate staff reductions began in the fourth quarter of 2001, well in advance of any knowledge of the ramifications of Enron's collapse and the energy market downturn on Aquila. Staff realignment was the result of a return to a state based utility organization and restructuring to meet staffing and performance metrics that we had successfully achieved in our international utility operations and believed could be achieved domestically. The objective of this exercise was to reduce costs borne by our customers while maintaining service performance. Subsequently, additional staffing reductions were announced but substantially all of these have been related to the continuing downsizing of our merchant operations. Aquila offers to conduct a detailed briefing of Staff and Commissioners in January on the performance metrics that are being monitored, the trend in these metrics, and the plans in place to address any emerging issues. For example, recognizing the aging profile of the current field employees, an additional 19 apprentice / linemen positions have been added to the 2003 Missouri electric operations budget.

2. Aquila acknowledges that as a result of its past growth of non-regulated businesses, corporate overhead costs were assigned over a larger entity and as a result, charges to utility customers were reduced. Likewise, we agree with the Staff's observation that with the elimination of our merchant business, the corporate overheads, while having been substantially reduced, will now

be allocated over a smaller entity. There is no doubt that some economies of scale, which have benefited the utility customers, will be lost with the elimination of merchant operations. However, Aquila also recognizes that any corporate overhead charges allocated to the utility should be reasonable and necessary for the conduct of the regulated utility business.

3. The Report expressed a concern that record-keeping commitments made to the Commission in the Stipulation resulting from Case No. ER-2001-672 could be negatively impacted. Earlier this year, representatives of Aquila met with members of the Staff and Office of Public Counsel to demonstrate our new ledger formats and our adherence to the Stipulation. No negative comments have been received to indicate that we have not complied with the record-keeping requirements. Aquila reiterates its commitment to comply with the Stipulation.

4. Aquila agrees with the Staff Report in regard to the potential impact of current financial conditions on its corporate capital structure and financing costs. Aquila reiterates its ongoing support for the use of appropriate hypothetical capital structures in order to insulate customers from the potential impact of non-regulated activities.

5. We note the Staff's concern in the Report of the potential for undue reliance on purchased power and/or operating leases to meet our generating capacity requirements. As noted in our recent integrated resource planning presentation to members of Staff and the Office of Public Counsel, Aquila analyzes numerous resource options on an ongoing basis to develop both short and long-term resource plans. In our most recent presentation, these analyses were narrowed to approximately fourteen options including a number of self-build, lease and purchase options. Our analyses, which continue to be updated, are impacted by multiple factors. The options and timing of additional capacity acquisition will ultimately be pursued according to what we believe is in our customers' best interests.

6. The Staff Report correctly points out that customer complaints have increased in 2001 and 2002 over prior years and reasons that some of this increase is likely due to the major ice storm in our service territory in early 2002 as well as the rate case filed in 2001. Unfortunately, these complaint statistics are not denoted by type nor whether they are actual complaints versus simple inquires. In addition to the extenuating circumstances noted in the Report, we have noted a significant increase in inquires from the St. Joseph Light & Power service territory as a result of the acquisition consummated in 2001 and the severely cold weather in the winter of 2000/2001. We also note that the initial increase in customer complaints occurred in early 2001, and is therefore unrelated to any changing energy market conditions, which did not manifest until approximately a year later.

7 Aquila agrees with the Report's observation that regular reports on employee turnover rates can be an important and effective management tool. In fact, management monitors turnover rates. As noted in the Report, Aquila does not maintain customer service turnover rates for customer services personnel distinguished by electric or gas classifications or segregated by MPS or L&P business units. As discussed with Staff, this is because our customer services personnel are not classified in these convenient "buckets". Call center personnel, for example, respond to both gas and electric inquiries and may handle inquiries from a number of states. Overall customer services turnover statistics were provided in a supplemental data response.

8. The Staff Report incorrectly suggests that Aquila does not maintain historical tracking of completed service orders at month-end. In response to a Staff request inquiring as to the number of service orders <u>not</u> completed at month-end, Aquila responded in part, "We do not maintain historical tracking of service orders "not" completed at month end." Aquila agrees that a comparative number of incomplete service orders at month-end, accumulated over a number of months, could provide a valuable metric in determining whether the level of incomplete service orders is rising, falling or stable. We will consider adding this metric to our management tools. However, we continue to believe that the process of real-time monitoring of customer service orders in process provides better customer service than a management by exception approach.

9. The Report correctly cites a decline in performance metrics in regard to our Call Centers' Average Speed of Answer and Abandoned Call Rate. Aquila acknowledges that this issue has been identified internally, is a matter of significant concern to the Company, and as indicated in the Staff's Report is being proactively addressed by management.

Again, Aquila would like to thank the Staff for its conscientious efforts in developing this Report and its factual representations. We are committed to achieving a high standard of quality service, reliability, and safety performance at fair and reasonable rates to our customers. We understand the Commission's interest in the financial condition of our company and look forward to working cooperatively with the Commission and its Staff as we navigate through these trying economic times.

Thank you

Jon R Empson

Jon R. Empson
Sr. Vice President Regulatory, Legislative
and Gas Supply Services

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
William L. Massey, and Nora Mead Brownell.

Westar Energy, Inc. Docket No. ES02-51-000

ORDER CONDITIONALLY GRANTING AUTHORIZATION TO ISSUE LONG-TERM UNSECURED DEBT AND ANNOUNCING NEW POLICY ON CONDITIONING SECURITIES AUTHORIZATIONS

(Issued February 21, 2003)

1. In this order, the Commission will grant Westar Energy, Inc.'s (Westar, formerly Western Resources, Inc.) request to issue long-term, unsecured debt, but will do so conditionally with restrictions on this authorization. In addition, the Commission intends that all future issuances of secured and unsecured debt authorized by the Commission will be similarly conditioned. This order benefits customers by ensuring that the authorization of a public utility to issue securities accords with the requirements of section 204 of the Federal Power Act (FPA).[1]

Background

2. On September 6, 2002, Westar submitted an application pursuant to section 204(a) of the FPA[2] seeking authorization to issue long-term, unsecured debt in an amount not to exceed $650 million at any one time. Westar also requests a waiver of the Commission's competitive bidding and negotiated placement requirements at 18 C.F.R. § 34.2 (2002).

3. On November 1, 2002, the Director of the Office of Markets, Tariffs, and Rates' Division of Tariffs and Market Development-Central requested additional information from Westar. Westar filed its response on November 15, 2002 (Westar Response). Westar, among other things, provided details related to its existing soon-to-mature debt

[1]16 U.S.C. § 824c (2000).

[2]16 U.S.C. § 824c(a) (2000).

securities,[3] its proposed debt issuance and why it believes the proposed issuance of the long-term, unsecured debt is in the public interest.

Notice, Interventions and Motions

4. Notices of the application and the data request response were published in the Federal Register, 67 Fed. Reg. 59,058 (2002) and 67 Fed. Reg. 70,725 (2002), respectively. The Kansas Commission filed a notice of intervention and comments on October 2, 2002. MBIA Insurance Company (MBIA) submitted timely motions to intervene and comments on October 3, 2002, and December 11, 2002.

5. The Kansas Commission states that the Commission should view Westar's application in the context of concerns about the capital structure and debt obligations of Westar and its affiliates.[4] The Kansas Commission also states that the Commission should not construe its filing as a request to deny Westar financing. However, the Kansas Commission emphasizes that its decision not to protest is based and conditioned upon Westar's declarations that the proceeds will be used solely to retire existing debt and that any debt issued will be "unsecured."[5]

6. MBIA insures approximately $500 million of bonds secured by the first mortgage pledge of Westar and its subsidiary, Kansas Gas and Electric Company, and closely tracks Westar's financial health. MBIA states that it has become alarmed at what it views as recent indications regarding troubling financial and management issues with Westar,[6] and that Westar's application contains scant information on how Westar's proposed issuance will relate to Westar's strained financial status. MBIA encourages the

[3]Westar's pre-existing debt issuances were authorized by either this Commission or the Kansas Corporation Commission (Kansas Commission) with no conditions imposed on how much of the borrowings could be used for non-utility businesses or the amount of Westar's assets that could be used to secure the debt.

[4]See Kansas Commission Notice of Intervention at 2.

[5]Id. at 3-4.

[6]MBIA notes: (1) an anticipated Kansas Commission order requiring a comprehensive restructuring, (2) reports of grand jury investigations of company executives and (3) Westar's efforts in seeking an exemption from limitations imposed by the Investment Company Act of 1940.

Commission to exercise appropriate due diligence to ensure that the standards of section 204 are met and that the issuance of the securities will not lead to further deterioration.[7]

7. On October 18, 2002, Westar submitted an answer in response to the Kansas Commission's and MBIA's comments.

8. On November 26, 2002, the Kansas Commission filed a motion to lodge its Order No. 51, requiring financial and corporate restructuring by Westar. This order requires Westar to obtain Kansas Commission approval before the issuance of any debt, to structurally separate its utility subsidiaries from its non-utility businesses and to reverse certain accounting transactions among its affiliates. Order No. 51 also provides that Westar should take steps to reduce its debt, utilizing available cash flow from electric operations to reduce non-utility debt secured by utility assets. The Kansas Commission states that Westar should consider the sale of subsidiaries Protection One, Inc. and ONEOK, Inc. stock, and a reduction of dividends.[8]

9. On January 6, 2003, the Kansas Commission filed a motion to lodge its Order No. 55, clarifying Order No. 51. Among other things, Order No. 55 clarifies Westar's financial and corporate restructuring requirements; establishes an August 1, 2003, restructuring deadline; requires monthly progress reports on Westar's debt reduction; affirms that Westar must reduce secured utility debt by $100 million per year from cash flow; affirms that the appropriate amount of debt after the restructuring is $1.47 billion; and affirms the Kansas Commission's authority to require Kansas Commission approval before the issuance of any additional debt.[9]

Discussion

Procedural Matters

10. Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.214 (2002), the notice of intervention and timely, unopposed motion to intervene serve to make the parties that filed them parties to this proceeding. Rule 213(a)(2) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213, prohibits answers to protests unless otherwise permitted by the decisional authority. We

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[7] See Motion to Intervene at 1-2.

[8] See Motion to Lodge Order No. 51 at 1-2.

[9] See Motion to Lodge Order No. 55 at 2-3.

do not find that good cause exists to allow Westar's answer, as it does not provide additional information assisting us in the decision-making process.

11. Rule 212(a)(2) of the Commission's Rules of Practice and Procedure allows motions to be filed by participants who have filed timely, interventions that have not been denied.[10] Accordingly, the Commission accepts, and the Commission will grant, the Kansas Commission's motions to lodge Order Nos. 51 and 55.

Westar's Conditional Securities Authorization

12. Section 204(a) of the FPA provides that requests for authority to issue securities or to assume liabilities shall be granted if the Commission finds that the issuance:

> (a) is for some lawful object, within the corporate purposes of the applicant, and compatible with the public interest, which is necessary or appropriate for or consistent with the proper performance by the applicant of service as a public utility and which will not impair its ability to perform that service, and (b) is reasonably necessary or appropriate for such purposes.[11]

13. The Commission concludes that Westar's requested authorization, as conditioned below, meets the standards of section 204.

14. The Commission finds that the proposed issuance of long-term, unsecured debt is for a lawful object within Westar's corporate purposes and is necessary, appropriate and consistent with Westar's performance as a public utility. Westar states it will issue the proposed debt in the second quarter of 2003 and use the proceeds to refinance debt that effectively matures in August 2003 by virtue of a put/call agreement.[12] Westar also states it is refinancing the unsecured debt in order to meet the requirements of a bank credit agreement requiring the debt to be retired 60 days prior to maturity and that without the ability to refinance Westar could potentially face a liquidity crisis.[13] Refinancing or retiring debt is a lawful object and is routinely practiced in the electric industry. The Commission further finds that the authorization, as conditioned below, is necessary and

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[10]See 18 C.F.R. § 385.212 (2002).

[11]16 U.S.C. § 824c(a) (2000).

[12]See Application at 2-3; Westar Response 7.

[13]See Westar Response 7.

appropriate, giving Westar, a non-investment grade issuer,[14] the flexibility necessary to refinance its debt securities with the most favorable terms.

15. In reviewing filings under section 204, the Commission evaluates a utility's financial viability based on a review of the financial statements submitted in the application and the utility's interest coverage ratio. An interest coverage ratio is a measure of the utility's ability to meet future debt and interest payments.[15] Westar's pro forma interest coverage ratio is less than what the Commission would typically prefer due in large part to approximately $657 million of non-cash charges from its non-utility subsidiaries that negatively impacted Westar's financial statements. However, Westar has a bank covenant requirement in place, similar to the Commission's interest coverage ratio, whereby Westar must attain a minimum ratio of consolidated earnings before interest, taxes, depreciation, and amortization to consolidated interest expense of 2.0 to 1.0. Westar's ratios on an actual and pro forma basis are 2.7 to 1.0 and 2.5 to 1.0, respectively, and as these ratios show, Westar meets the bank covenant requirement both before and after the proposed financing.[16]

16. In evaluating Westar's financial viability, the Commission also reviewed Westar's debt maturities and cash flow projections over the next five years. While Westar's debt maturities between October 2002 and December 2007 total more than $2.7 billion, Westar projects it will be able to meet these obligations as they come due.[17] Westar also projected a free cash flow remaining after the payment of interest and dividends in excess of $115 million for each of the next four years[18] and states it will be used to further reduce company debt.[19]

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[14]See Westar Response 7. Independent credit agencies, such as Standard and Poor's and Moody's Investors Services, rated Westar's unsecured debt securities as BB- and Ba2, respectively, with negative outlooks. See Application at 2.

[15]The interest coverage ratio is a calculation of income before interest and taxes divided by total interest expense.

[16]See Westar Response 6.

[17]See Westar Response 12.

[18]Westar calculates free cash flow by adding depreciation and amortization to net income, then subtracting capital expenditures and stock dividends.

[19]See Westar Response 12.

17. The Commission has considered all the above information concerning Westar's financial viability.[20] While we recognize that Westar's financial condition has deteriorated, in large part due to its non-utility business activities, without the proposed authorization to refinance soon-to-mature debt Westar could face a liquidity crisis, ultimately harming the public interest.

18. We also note that authorization can be granted only if doing so will be consistent with Westar providing public utility service and will not impair its ability to provide such service. We believe that with the conditions ordered below we can make this finding.

19. Therefore, the Commission will conditionally authorize Westar's request to issue long-term, unsecured debt in an amount not to exceed $650 million, subject to the following conditions.[21] First, the proceeds of the debt must be used solely for the purpose of retiring outstanding indebtedness, including accrued and unpaid interest due at maturity. Second, Westar is required to file quarterly informational status reports

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[20]The Division of Regulatory Audits in the Commission's Office of the Executive Director performed an audit and found that since 1995 Westar has issued substantial amounts of new debt and used the proceeds to finance non-utility business ventures and to cover operating losses incurred by non-utility businesses. The audit report identifies the following adverse consequences: the credit rating for Westar securities is "junk status;" Westar debt is more costly and more difficult to obtain on economically favorable terms; Westar's ratepayers are at risk for paying the increased cost of debt if Westar cannot generate enough cash flow from utility operations to cover the increased debt costs; and Westar will be left with a disproportionate amount of debt if it "spins off" some or all of its non-utility businesses.

[21]The scope of the Commission's jurisdiction over securities issuances is limited. For example, section 204 of the FPA does not apply to a public utility organized and operating in a state where its securities issuances are regulated by a state commission. See, 16 U.S.C. 824c(f) (2000). The Kansas Commission follows a similar statute whereby it must authorize the issuance of long-term securities unless the issuance requires a registration statement to be filed with the Securities and Exchange Commission or the public utility obtains authorization from another state or federal agency. See K.S.A. § 66-125 (2001). As directed in Order Nos. 51 and 55, for all future securities authorizations Westar must receive Kansas Commission approval before the issuance of any future debt. Thus, as long as Westar complies with this requirement it will not need our approval prior to such issuance. Westar should, however, file with us an informational copy of any future securities issuance applications that are subject to approval by the Kansas Commission.

detailing its financial condition and debt-reduction efforts within 30 days of the end of each calendar quarter. Third, Westar must file a Report of Securities Issued within 30 days after the sale or placement of the long-term, unsecured debt, as stated in the Commission's regulations.[22] Finally, Westar must also abide by the following restrictions on secured and unsecured debt.

20. The Commission will impose four additional restrictions and it is the Commission's intention that these restrictions will be applied to all future public utility issuances of secured and unsecured debt authorized by this Commission.[23] First, public utilities seeking authorization to issue debt that is secured (i.e., backed) by utility assets must use the proceeds of the debt for utility purposes only. Second, with respect to such utility asset-secured debt issuances, if any utility assets that secure such debt issuances are divested or "spun off," the debt must "follow" the asset and be divested or "spun off" as well.

21. Third, if assets financed with unsecured debt are divested or "spun off," the associated unsecured debt must follow those assets. Specifically, if any of the proceeds from unsecured debt are used for non-utility purposes, the debt likewise must "follow" the non-utility assets and if the non-utility assets are divested or "spun off" then a proportionate share of debt must "follow" the associated non-utility assets by being divested or "spun off" as well. Last, with respect to unsecured debt used for utility purposes, if utility assets financed by unsecured debt are divested or "spun off" to another entity, then a proportionate share of the debt also must be divested or "spun off".

22. These restrictions should prevent public utilities from borrowing substantial amounts of monies and using the proceeds to finance non-utility businesses. These restrictions thus should ensure that future issuances of debt are compatible with the public interest, will not impair a public utility's ability to perform in the future and provide appropriate ratepayer protection.[24]

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[22]See 18 C.F.R. §§ 34.10, 131.43 (2002).

[23]MBIA recently testified at the Commission's January 16, 2003, technical conference on capital availability for energy markets, citing concerns that holding companies use assets of regulated utilities to keep shaky unregulated ventures afloat. MBIA requested that the Commission take a more active role in analyzing proposed securities issuances and use its section 204 authority to rigorously evaluate how debt will be used. See 16 U.S.C. § 824c(a) (2000).

[24]These restrictions are also consistent with the audit report discussed above. See (continued...)

Information to be filed in Future Section 204 Applications

23. Part 34 of the Commission's regulations sets out the filing requirements for public utilities seeking Commission authorization of the issuance of securities or the assumption of liabilities.[25] In order for the Commission to determine if a security issuance is in the public interest, an application for authority to issue securities must contain, among other things, certain corporate information, a statement as to whether or not any state regulatory body requires an application for authorization to issue the securities, a summary of any rate changes that may apply during or after the period of the issuances, along with accompanying exhibits.[26]

24. The Commission takes this opportunity to remind public utilities that they must include in their applications all information required in Part 34 of the Commission's regulations. Specifically, public utilities must include information on the amount, type, maturity date and whether any of the proposed debt issuances will be secured or unsecured. Public utilities also must provide a detailed explanation of the purpose for the requested securities and state if the issuance will be used for utility or non-utility purposes. Public utilities must explain how the proposed issuance meets the standards of section 204(a), rather than merely making a declaration that it does so. Finally, the board of directors' resolutions must include a discussion of the type, amount, and purpose of the proposed issuance and the financial statements should be calculated on both an actual and pro forma basis.

25. We also remind public utilities that section 204 gives the Commission the authority to issue supplemental orders, and modify the provisions of any previous order as to the particular purposes, uses, and extent to which, or the conditions under which, any security or the associated proceeds may be applied.[27] Westar as well as other public utilities are hereby put on notice that the Commission plans to review the required filings and reports, and may issue supplemental orders as necessary.

26. Finally, while state regulatory authorities may not have approval over a public utility's request for authority to issue securities or assume liabilities filed with the

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[24](...continued)
supra note 20.

[25]See 18 C.F.R. Part 34 (2002).

[26]Id. at §§ 34.3 through 34.9.

[27]See 16 U.S.C. § 824c(b) (2000).

Commission pursuant to section 204 of the FPA, we recognize such matters can have a significant impact on the applicant's ability to perform its public utility obligations at the retail level. Thus, the Commission would find the views of the state commissions with retail rate jurisdiction over section 204 applicants helpful and we encourage those commissions to file comments in section 204 proceedings.

The Commission orders:

(A) Westar is hereby conditionally authorized to issue long-term, unsecured debt in an amount not to exceed $650 million at any one time, under the terms and conditions and for the purposes specified in the application and this order, subject to the conditions discussed in the body of this order.

(B) Westar's requested waiver of the Commission's competitive bidding and negotiated placement requirements at 18 C.F.R. § 34.2 is hereby granted.

(C) This authorization is effective as of the date of this order and terminates two years thereafter.

(D) The authorization granted in Ordering Paragraph (A) above is without prejudice to the authority of the Commission with respect to rates, services, accounts, valuation, estimates, or determinations of cost, or any other matter whatsoever now pending or which may come before the Commission.

(E) Nothing in this order shall be construed to imply any guarantee or obligation on the part of the United States with respect to any security to which this order relates.

(F) The Secretary is hereby directed to publish this order in the Federal Register.

By the Commission.

(S E A L)

Magalie R. Salas,
Secretary.

Schedule 3

is deemed

Highly Confidential

in its entirety.