

**STATE OF MINNESOTA
BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION**

**Gregory Scott
Marshall Johnson
LeRoy Koppendraye
Phyllis Reha**

**Chair
Commissioner
Commissioner
Commissioner**

**In the Matter of an Inquiry into Possible
Effects of the Financial Difficulties of Aquila,
Inc. on Peoples Natural Gas Company and
Northern Minnesota Utilities Company**

**MPUC Docket No.:
G007,011/CI-02-1369**

AQUILA REPLY COMMENTS

These Reply Comments are submitted by Aquila, Inc. in response to the Department of Commerce ("DOC") October 22, 2002 Comments in the above-entitled docket. The DOC acknowledges that the "Company has taken aggressive steps to improve liquidity and remove debt from its balance sheet. Although these measures have, as of yet, failed to improve the Company's debt ratings, Aquila's long term strategy seems to offer the Company the best route to financial security and continued viability." No one is more concerned about the Company's financial health or working harder to improve it than its management. The Company has addressed its financial problems openly and vigorously.

In June, when Aquila realized that financial problems were occurring in the industry that were affecting its own financial condition, Aquila initiated contact with the Commission and requested the opportunity to discuss those matters. Scheduling problems prevented that from occurring until August 20. Commission Staff also contacted Aquila personnel on August 14, 2002 to give the Company notice that the Commission's August 29 agenda would include an initial inquiry into the possible effects of Aquila's financial difficulties on Peoples and NMU. During this contact, Staff

requested copies of Aquila's most recent 10Q, 10K and FERC investigation filings. Aquila e-mailed copies of these documents the same day in order to help the Staff complete its review and briefing paper in time for the August 29 agenda meeting. Staff also advised Aquila of its general concerns and questions, which Mike Jonagan, then CEO of U.S. Utilities, attempted to address in his August 26, 2002 letter to the Commissioners. The sole purpose of providing this letter prior to the August 29 agenda meeting was to provide the assurances that Aquila understood the Commission wanted.

Based on its general understanding of the Commission's concerns, Aquila arranged on short notice for Mike Jonagan, then CEO U.S. Utilities; Jon Empson, Senior V.P.; Bennie Smith, Operating V.P. Minnesota; and Mike Cole, Assistant Treasurer, to participate in the August 29 Commission agenda meeting to ensure that all questions could be addressed.

With this Reply, Aquila continues to cooperate with the Commission and the DOC in a spirit of responsiveness and openness, providing a further update on Aquila's current financial condition, providing a further explanation of its foreign utility investment arrangements, and responding to the DOC's specific recommendations and concerns.

1. The Company's Current Financial Condition.

Since the August 29 hearing and the September 18 compliance filing, Aquila has made significant progress in closing several asset sales. As of October 29, the sale of \$977 million of assets has been announced, of which \$797 million have been closed. While the asset sales are raising cash to retire debt, the full impact of the transactions is also creating net book losses and lowering the earnings potential of Aquila. Aquila has also continued to restructure its businesses and, as discussed in the second quarter

10Q, anticipates a second phase of restructuring charges to be reflected in the third-quarter results. Given the speed with which the Company has been executing the business restructuring and the closing of asset sales, Aquila now expects that the credit rating agencies could review the current ratings when Aquila announces its third quarter earnings in early November. Attachment A to this filing is a copy of Aquila CEO, Rick Green's October 22 presentation at EEI's Financial Analyst Conference which presentation contained financial updates. Aquila provided copies of this presentation to Staff and DOC via e-mail the day the presentation was made to ensure that current information was available to the agencies.

2. The Company's International Utility Investment Arrangements.

The DOC's comments find fault with how the Company explained some of its foreign debt arrangements. As further explained below, the Company's international utility investments were openly presented to, and approved by, the Commission at the time they were made. Those acquisitions and financing arrangements were nothing out of the ordinary for these types of transactions and were related to utility operations, not unregulated operations as inferred. Aquila elected to acquire foreign utilities to reduce its risk by making investments in more than one economic market.

The DOC found Aquila's explanation of its foreign investment financing confusing. Hopefully the following explanation will eliminate this confusion. Basically, there were two tiers of financing involved: debt at the operating company level and debt to support Aquila, Inc.'s equity investments in the international operating companies. The debt at the operating company level is non-recourse to Aquila, is not guaranteed by Aquila, and does not cross-default to Aquila (see p.5 of Aquila's September 18

Compliance Filing). Contrary to DOC's concerns, none of this debt was, nor should it be, included in the potential capital calls discussed in either the 10Q or in the Company's response to Information Request No. 7.

In contrast, the debt incurred to make the "equity investment" in the international utilities is, in some instances, guaranteed by Aquila and those guarantees usually include cross-default language (again see p.5 of Aquila's September 18 Compliance Filing). The nature of the foreign investments, including any guarantees, was disclosed in Aquila's filings with the Minnesota Commission and reviewed by the Department of Public Service ("DPS") at the time of the investments. The Commission, with the DPS' concurrence, approved those foreign investments and, where applicable, loan guarantees in four separate dockets. See the Commission's June 15, 1993 Order Granting Limited and Conditioned Certification, in Docket No. G011/S-93-281 ("Docket 281"); November 30, 1994 Order Granting Certification Subject to Limitations and Conditions, in Docket No. G011/S-94,-907; June 9 1995 Order Finding Authority, Resources and Intent to Use Them and Requesting Filings and July 18, 1995 Order Granting Recertification, in Docket G011/S-95-204 (involved a guarantee); and the August 17, 1998 Order Granting Certification with Conditions, in Docket No G007, 011/S-98-682 (involved a guarantee). In each of these dockets, the manner of financing, including any loan guarantees was disclosed. In addition, based upon the disclosed information, the Commission was aware of the potential risk associated with these foreign investments. For example, in Docket 281, the Commission expressly noted that because Peoples and NMU receive all of their financing from UtiliCorp, any "increase in financial risk due to its purchase of an interest in [a foreign utility] . . . may

result in an increased cost of capital." The Commission further noted, however, its ability to protect the ratepayers from these potential risks by establishing an appropriate cost of capital. This historical perspective is provided only to demonstrate that the nature of the investments were disclosed and discussed at the time the transactions took place.

It is the debt securing Aquila's equity interest in the foreign utilities which had some call potential and was disclosed by Aquila in the 10Q, in the September 18 Compliance Filing, and in the response to Information Request No. 7. It is this important distinction between debt at the operating company level versus the debt to fund the equity investment which appears to have created confusion.

If after reviewing these comments there is continued confusion or if the DOC has additional questions, the Company recommends a face-to-face meeting with DOC staff so that it can either further clarify or provide the DOC the information it is seeking. While written information requests provide a record of the information exchanged, they are difficult to write in a manner that assures receipt of all of the desired information and therefore can sometimes lead to confusion and frustration as appears occurred in this case.

3. Responses To Specific DOC Recommendations.

a. Comments On The Commission's Jurisdiction In The Event Of Bankruptcy.

The DOC recommends that Aquila provide a full and complete report analyzing Aquila's belief that Minn. Stat. § 216B.50 will continue to protect ratepayers' interests in the event of an Aquila bankruptcy. Aquila's understanding of the current landscape of the preemption of the U.S. Bankruptcy Code (the "Code") over state law would be in no

way superior to that of the Commission's representative from the Minnesota Attorney General, nor would it carry any more precedential or binding value for the Commission. However, given the Commission's recognized interest in the effect a bankruptcy would have on the Commission's regulatory jurisdiction over a utility, Aquila offers its belief and understanding here, reserving all rights to make any legal arguments available under applicable law in the future.

As operating divisions of the corporate entity Aquila, Inc., Aquila's Peoples and NMU operations and assets would fall under the jurisdiction of a bankruptcy court if Aquila were to seek the protections allowed under the Code. Minn. Stat. § 216B.50 requires Commission approval of any sale of a public utility or of an operating system valued over \$100,000, but the question remains: Would the Code, and judicial decisions thereunder, operate to preempt the Commission's authority under Section 216B.50. Unfortunately, Aquila has found no Eighth Circuit or U.S. Supreme Court decisions that address this issue. Even if Aquila exhaustively canvassed the cases of every jurisdiction in the United States, there is no guarantee that a specific bankruptcy court would decide the same way in a potential Aquila case.

Subject to the above caveats, Aquila is aware of no bankruptcy cases in which a court has approved and ordered the sale or transfer of utility assets outside the jurisdiction of the relevant state public utility commission. In fact, in one case, the court made its approval of a sale of assets outside the ordinary course of business during bankruptcy expressly subject to regulatory approval. In re WFDR, 7 BCD 514 (Bkr. Ct. N.D. Ga. 1981). Accordingly, it is Aquila's belief that any transfers or sales that a court might order in an Aquila bankruptcy case would remain consistent with the practice of

respecting public utility commission jurisdiction over such sales and transfers.

Additionally, it is Aquila's understanding that if Peoples or NMU assets were sold in an Aquila bankruptcy, the Commission's jurisdiction over those assets would remain intact following such a sale (including with respect to future transfers, ratemaking, and other regulations), and no bankruptcy or other body of law appears to hold to the contrary.

However, pursuant to clear language contained in Section 1123(a) of the Code, a confirmed reorganization plan under Chapter 11 of the Code may provide for the transfer of assets "[n]otwithstanding any otherwise applicable nonbankruptcy law."

As discussed in the recent PG&E bankruptcy and related appellate proceedings in California, courts of various jurisdictions have debated whether the Section 1123(a) language provides for "express preemption" (obviating application of state law generally) or "implied preemption" (allowing preemption only in cases where (a) the applicable state statute is concerned with economic regulation rather than with protecting public health and safety and (b) no feasible plan would be confirmable in the absence of preemption). In the context of a preliminary matter in the PG&E case, the U.S. Bankruptcy Court for the Northern District of California analyzed the applicability of preemption with respect to a pre-confirmation disclosure statement and declared that a transfer of assets pursuant to a confirmed plan would not be subject to state regulatory approval. See In re Pacific Gas & Elec. Co., 2002 U.S. Dist. LEXIS 16499 (Aug. 30, 2002). Again, this decision relates to a preliminary disclosure statement, so it is not clear what the confirmed plan will ultimately look like or whether preemption will ever come to fruition.

With respect to the impact that Aquila's corporate structure may have to diminish or otherwise limit the protection that Minnesota ratepayers may have in the event of an Aquila bankruptcy, Aquila notes that under a Chapter 11 reorganization plan, the stock of the subsidiaries of a holding company could also be sold. Accordingly, while the corporate structure of the utility may be a consideration in the development of a confirmable reorganization plan, it would provide no guarantee of the Commission's continued jurisdiction over the transfer or sale of the utility.

b. Ratepayer Protections From Higher Capital Costs

In his letter to the Commission dated August 26, 2002, Mike Jonagan stated:

Aquila acknowledges that (a) Minnesota ratepayers should pay no more for debt costs than would be incurred by an investment grade utility, and (b) the Commission has the authority during the ratemaking process to use a hypothetical debt structure to address debt costs higher than those of an investment grade company, if such a case arises.

Thus, the Company agrees with the DOC that Minnesota customers should only be responsible for a cost of equity or debt consistent with the cost of capital for comparable gas distribution companies. The Company also agrees with the DOC's specific recommendations regarding the cost of capital.

It should be noted that during the pending rate case both the DOC and Aquila agreed on using a group of comparable gas distribution companies to determine the cost of equity. As stated by DOC witness Amit, "... a DCF analysis for UtiliCorp would not result in a reasonable estimate of the cost of equity for PNG and NMU. Instead, I have performed a DCF analysis on a group of companies with investment risks similar to those of PNG and NMU." (p.5, line 14-17 Direct.) DOC witness Amit continued by stating: "The obvious candidates are other gas distribution companies." (p.5, line 22-

23.) Company witness Dunn also used a comparable company approach to determine the cost of equity. The company position is the same today. Therefore, assuming that the DOC maintains its position, the solution to the cost of equity concerns raised by DOC has already been agreed to by both parties. That is, cost of equity should be determined using a group of comparable gas distribution companies rather than based directly on Aquila's cost of equity.

- DOC Recommendation: In Aquila's next rate case, the Company identify all issuance of debt and associated cost from January 1, 2002, until its next rate case in a manner that will facilitate a potential adjustment to mitigate impacts of adverse market factors caused by Aquila's financial problems. Specifically, the Company must provide information sufficient to allow the Commission to evaluate what Peoples' and NMU's debt and equity costs would be but for the effects of its other operations.

Response: Agreed. As stated by Mike Jonagan in his August 26 letter to the Commission, Aquila has already made this commitment on debt, and has adopted a methodology for equity that addresses the DOC's concerns, and therefore agrees with DOC's recommendation.

- DOC Recommendation: The Company provide a discussion and analysis in its next rate case of the effects at that time of Aquila's financial situation on Peoples' and NMU's costs of common equity.

Response: Agreed. Again, unless the DOC and/or Commission were to set rates using Aquila, Inc.'s actual cost of equity, rather than a proxy based on comparable gas distribution companies such as Aquila, DOC,

and the Commission have used in other Company rate cases, this should not be an issue.

- **DOC Recommendation:** Aquila should report immediately any significant financial event for Aquila and provide copies of any report made to the SEC or any other federal agency from now on.

Response: Agreed. The Company's web site provides the opportunity for all interested persons to obtain automatic notice of all significant financial events including copies of all SEC filings. Anyone wishing to receive such automatic notices can go to the Company's website: www.aquila.com.

On the home page, click on the heading "Investors", and then click on "Investor Contacts & Information". Then sign up for

E-mail Alerts, which provides automatic notice of news releases, company events, new financial documents, including notice of SEC filings. The Company's SEC filings are also accessible using the Company's web site, by clicking on the word "Investors" and then clicking on "SEC Filings" and then clicking on the direct link to a third-party service that provides copies of the filings by name and also in a searchable format.

- **DOC Recommendation:** In its Reply Comments the Company should explain why it did not file for Commission approval of its most recent debt issuances.

Response: Foreign corporations like Aquila, which is a Delaware corporation, are only required to obtain Commission approval of a security issuance if it encumbers Minnesota utility property for the purpose of

securing the debt. As the DOC acknowledges in footnote 10, Commission approval of the credit facilities was not required because "Minnesota property was not specifically used to secure any credit facilities . . ."

More specifically, Minn. Stat. § 216B.49, subd. 3, provides:

It shall be unlawful for any public utility organized under the laws of this state to offer or sell any security or, if organized under the laws of any other state or foreign country, to subject property in this state to an encumbrance for the purpose of securing the payment of any indebtedness unless the security issuance of the public utility shall first be approved by the commission. Approval by the commission shall be by formal written order.

(Emphasis added.) None of the debt issuances referenced by the DOC encumbered any Minnesota property for the purpose of securing the payment of the indebtedness.¹

The above discussion of the Commission approval requirements under Section 216B.49, subd. 3, is further based on the Commission's interpretation of this section in Docket 281. In that Docket, the Commission stated:

The Commission also has other regulatory authority which would apply if certain aspects of the acquisition were changed. For instance, if the acquisition were modified to result in the encumbrance of any Minnesota property,

¹ As the DOC notes, the Company's revenues and property are always available to creditors in the case of a bankruptcy, but that is not an encumbrance. Minn. Stat. § 336.2A-309 of the Uniform Commercial Code defines an encumbrance to include "real estate mortgages and other liens on real estate and all other rights in real estate that are not ownership interests." An encumbrance limits the ability of the owner of the property to sell the property and allows the debt holder to force the sale of the asset in the event of a default. None of the Company's debt issuances placed a lien on Minnesota utility property. The DOC notes that the Company is subject to the federal bankruptcy laws. The potential application of the bankruptcy laws is not a lien on the Company's Minnesota property. Further, because of the universal application of bankruptcy, if it were treated as a lien, it would render the exemption from Section 216B.49 meaningless. Minn. Stat. § 645.17 provides the following prescription in interpreting legislation: "the legislature intends the entire statute to be effective and certain."

Commission approval of UtiliCorp's resulting capital structure would be required under Minn. Stat. § 216B.49, subd. 3 (1992).

c. Quality of Service Standards.

The DOC requests that the Company propose a gas service quality standards plan, including information on how service quality response times will be recorded. The Company previously agreed to voluntarily provide internal management reports which will reflect the Company's standards for accidents, leaks, emergency response time, meter reading, billing accuracy, and overall customer satisfaction. The Company further explained its intentions with respect to these reports in response to a DOC data request.

The purpose of these reports is to assist the Company in managing its operations. Over time, it is expected that the areas studied will change in response to newly identified issues. The Company recommends that the Company and DOC meet and review the internal management reports and see if the content addresses the DOC's concerns. The Company requests that the Commission not seek to regulate this management tool. Nor should the Commission order specific service quality standards absent either a rulemaking proceeding or a specific service quality problem and evidence on the reasonableness of the standard as applied to Aquila. For example, the standards developed for NSP for emergency response times reflects that Company's largely urban setting and should not apply to Peoples and NMU, which serve a very large and significantly more rural area.

CONCLUSION

Aquila has attempted in this proceeding to provide the Commission, its Staff and the DOC with detailed information about Aquila's current financial condition. Aquila initiated the discussions, made senior management available for questions, made all

SEC and FERC filings available, and responded to all information requests in a comprehensive manner. Aquila hopes that this Reply clarifies any confusing aspects of the Compliance Filing. Aquila remains very willing to continue to provide complete and candid responses to all of the Commission's and DOC's questions.

Dated: November 1, 2002

Respectfully submitted,

By Michael J. Bradley
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Attorneys on Behalf of Aquila, Inc.



Transitioning from an Energy Merchant to an Integrated Utility

EEI / October 2002

ATTACHMENT A



Forward Looking Statements

- The statements made with respect to Aquila's earnings and outlook for the future contain some forward-looking information. Naturally, all forward-looking statements involve risk and uncertainty and actual results or events could be materially different. Although Aquila believes that its expectations are based on reasonable assumptions, it can give no assurance that its goals will be achieved.
- Important factors that could cause actual results to differ include: unusual weather conditions; economic and financial market conditions, including changes in exchange rates, interest rates, and commodity prices; changes in our credit rating; competition in the markets in which our businesses operate; and changes in applicable laws, regulations, or rules governing energy, environmental, tax, or accounting matters. In light of these risks, uncertainties, and assumptions, the forward-looking events discussed might not occur. Please review the company's latest annual report on Form 10-K, quarterly report on Form 10-Q, any current reports on Form 8-K, and recent press releases for other important factors that could cause results to differ materially from those in any such forward-looking statements.
- Information in these archived materials may not be current and may be superseded by more recent information published by Aquila.



Discussion Topics

- ▶ **Industry Issues**
- ▶ **Leadership Team**
- ▶ **Transition**
- ▶ **Asset Sales**
- ▶ **Liquidity**
- ▶ **ILA Challenges**
- ▶ **Current Priorities**

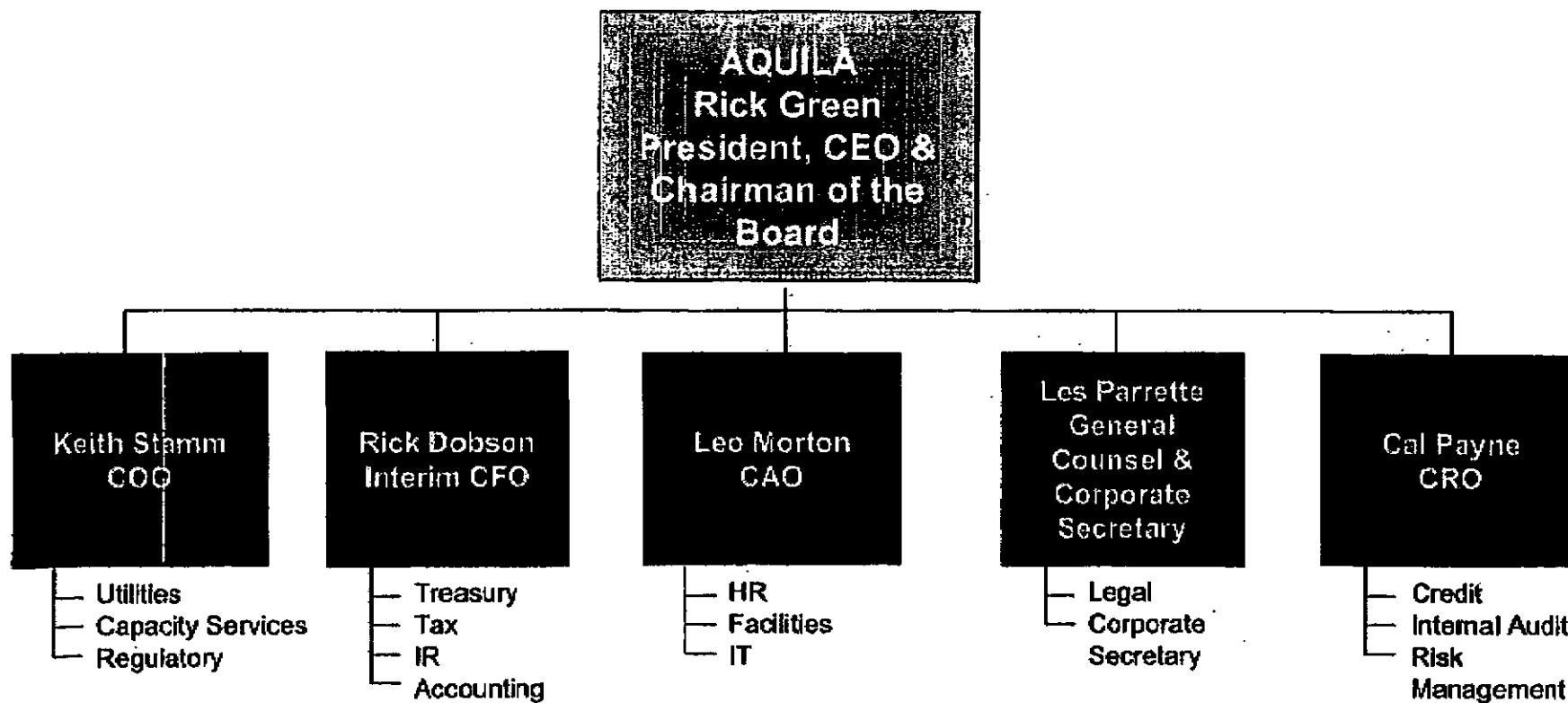


Industry Issues

- ▶ **Underestimated Impact of Enron Demise**
- ▶ **Credit and Liquidity Concerns**
 - No one is bullet proof
 - Cost of liquidity is infinite
- ▶ **Fundamentals Impacting Generation**
 - Supply & demand
 - Boom & bust cycle
 - Lack of liquidity
- ▶ **Outlook for 2003**
 - Continued over supply of generation
 - Backlog of asset sales
 - Uncertain capital markets



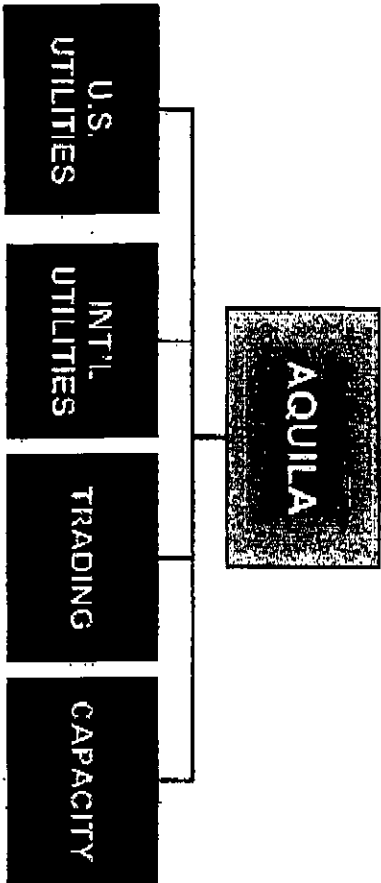
Leadership Team



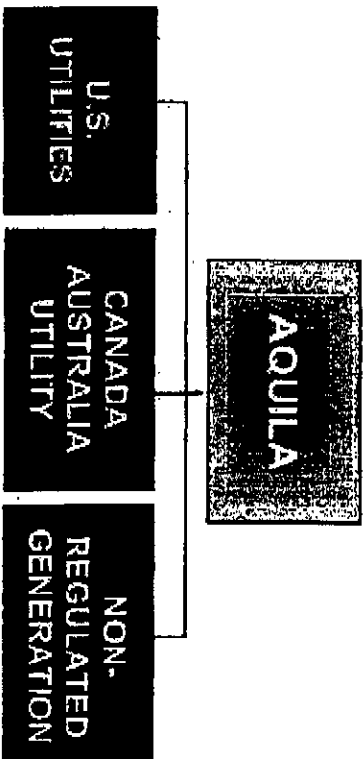


Aquila Overview (pro forma)

LAST YEAR



NEXT YEAR



TRANSITION

Selling:

- NZ
- UK
- Midstream
- Loan Portfolio
- Quanta



Asset Sales

DESCRIPTION	ESTIMATED CLOSING DATE	CASH PROCEEDS	ESTIMATED GAIN/(LOSS) AFTER TAX	2002 EBIT LOST	
SIGNED:					
▶ GAS GATHERING AND PROCESSING	CLOSED	\$265.0 M	\$(156 M)	\$20 M	Closed with ET Company
▶ LOCKPORT IPP	CLOSED	\$37.5 M	\$(5) M	\$6 M	Closed with Forlstar Capital
▶ NEW ZEALAND	CLOSED	\$362.0 M	\$28 M	\$31 M	Closed with Vector
▶ HOLE HOUSE STORAGE	CLOSED	\$34.9 M	\$(9) M	\$0 M	Closed
▶ QUANTA 16.4M SHARES	CLOSED	\$44.0 M	\$(5) M	\$12 M	Closed
▶ MALLON CREDIT	CLOSED	\$30.5 M	Not Available	Not Available	Closed with BlackHills
▶ OTHER ASSETS	CLOSED	\$22.7 M	Not Available	Not Available	Closed
▶ KATY STORAGE	11/1/2002	\$180.0 M	\$20 M	\$6 M	Pending close with PacifiCorp Power
		\$976.6 M	\$(127) M	\$75 M	
IN PROGRESS:					
▶ LOAN PORTFOLIO		-----NOT AVAILABLE-----			
▶ QUANTA 12.8M SHARES		-----NOT AVAILABLE-----			
▶ MIDLANDS		-----NOT AVAILABLE-----			

- Will achieve \$1 Billion plus in asset sales
- Proceeds will reduce debt
- Asset sales will require bank consents



Aquila

Liquidity - Estimated

SOURCES:

CASH ON HAND 9/30/02	\$515
REVOLVER CAPACITY (\$151 in LOC's)	99
LIQUID ASSETS	40
ASSET SALES - ANNOUNCED, NOT CLOSED 9/30/02	897
	<u>1,551</u>

OPERATING CASH FLOW

0

CAPITAL EXPENDITURES:

NETWORKS	(74)
CAPACITY	(15)
EVEREST	(31)
NET OPERATING CASH FLOW	<u>(120)</u>

SCHEDULED PAYMENTS:

DIVIDENDS	(34)
MIDLANDS BRIDGE	(194)
NEW ZEALAND	(127)
AUSTRALIA	(81)
	<u>(436)</u>

ESTIMATED NET LIQUIDITY 12/31/02

\$995



Collateral Calls Since Moody's Downgrade

DESCRIPTION	TOTAL ESTIMATED PER	MOODY'S ESTIMATED PER	AMOUNT POSTED
	2Q 10Q	2Q 10Q	
DEBT	\$177 M	\$85 M	* \$81 M
FINANCIAL	62 M	62 M	40 M
TOLLS & CONSTRUCTION LOAN	110 M	45 M	73 M
OTHER POTENTIAL DEMANDS	135 M	135 M	41 M
	\$484 M	\$327 M	\$235 M

* \$81M of debt was paid upon its maturity in October

- Better than expected results
- Downgrade reduced # of willing suppliers
- Reduced credit terms



ILA Challenges

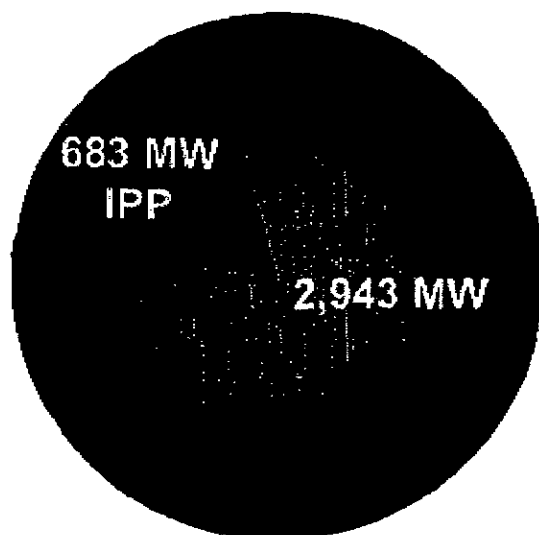
Challenges	Related Factors
ASSET SALES	<ul style="list-style-type: none">▶ Economic result, net loss▶ Accruing losses now▶ Execution risk (buyers' market)▶ Resizing corporation
NON-REGULATED GENERATION	<ul style="list-style-type: none">▶ High reserve margins▶ Low spark spreads▶ Lack of liquidity▶ Fixed costs
CAPITAL/BANK MARKETS	<ul style="list-style-type: none">▶ Cost of & access to capital▶ Need for self-reliance

Challenges result in moving targets on earnings and lack of visibility/clarity



Our Generation Portfolio - 2003

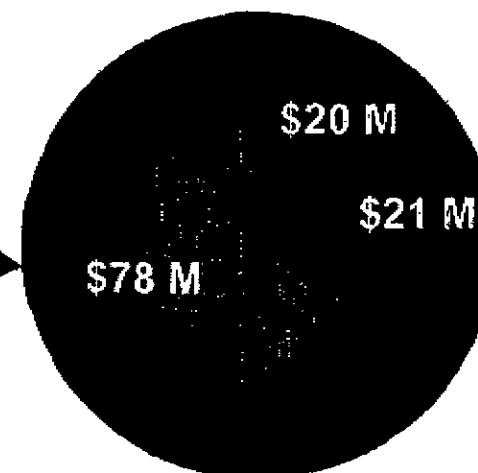
Total MWs



■ IPP MW'S

■ Merchant MW'S

Cash Economics



■ \$'s of Forward Sales Contracted

■ \$'s of Financial Hedges

■ \$'s of Unrecovered Capacity Costs

Answer Key:

- Forward Sales Contracted = P/L & cash flow both hedged
- Financial Hedge = Cash flow hedged; P/L MTM



Current Priorities - Stability

BUSINESS STABILITY

Domestic & International Utilities and Capacity Services

- Serve customers
- Optimize assets
- Improve relationships

FINANCIAL STABILITY

Improve Cash Flow

- Execute asset sales
- Control costs
- Manage banks
- Minimize collateral calls

CREDIBILITY

Commit & Deliver

- Communicate frequently
- Act as "one" company
- Inspire confidence

STATE OF MINNESOTA
BEFORE THE PUBLIC UTILITIES COMMISSION

Gregory Scott
LeRoy Koppendraye
Marshall Johnson
Phyllis Reha

Chair
Commissioner
Commissioner
Commissioner

In the Matter of an Inquiry Into Possible
Effects of the Financial Difficulties at Aquila,
Inc. on Peoples Natural Gas Company and
Northern Minnesota Utilities Company and
their Customers

Docket Number: G007,011/CI-02-1369

**REPLY COMMENTS OF THE OFFICE
OF THE ATTORNEY GENERAL**

INTRODUCTION

The Residential and Small Business Utilities Division of the Office of the Attorney General ("OAG") respectfully submits these Reply Comments in response to the Comments of the Minnesota Department of Commerce ("Department" or "DOC")¹ and the Compliance Filing² and responses to Information Requests of Aquila, Inc. ("Aquila") with respect to its Peoples Natural Gas Company-Minnesota ("Peoples" or "PNG") and Northern Minnesota Utilities ("NMU") divisions. These Reply Comments are restricted to the issue of Minnesota Public Utility Commission ("Commission") jurisdiction in the event of an Aquila bankruptcy.

¹ See Department's *Comments On Inquiry Into Possible Effects Of Financial Difficulties at Aquila, Inc. On Peoples Natural Gas and NMU and Its Customers*, MPUC Docket No. G007,011/CI-021369 (October 22, 2002).

² See *Compliance Filing In the Matter of an Inquiry Into Possible Effects Of Financial Difficulties at Aquila, Inc. On Peoples Natural Gas and NMU and Its Customers*, MPUC Docket No. G007,011/CI-021369 (September 18, 2002).

I. THE COMMISSION MAY LOSE JURISDICTION OVER REGULATION OF AQUILA ASSETS IN THE EVENT OF BANKRUPTCY.

In DOC Information Request Number 6 (October 4, 2002), the Department asked, "How are the Peoples' Natural Gas-Minnesota and Northern-Minnesota Utilities' assets insulated from a potential bankruptcy of Aquila, Inc.?" Aquila replied as follows:

Aquila's Minnesota PNG and NMU operations are conducted as a division of the corporate entity Aquila, Inc. Accordingly, if Aquila, Inc. were to file for protection under the bankruptcy laws, the assets held by that corporate entity (i.e., including its divisions) would fall under the jurisdiction of the bankruptcy court. However, it is Aquila's belief that Minnesota Statute § 215B.50 will continue to prohibit dispositions (in excess of \$100,000) of PNG's and NMU's assets without first obtaining Commission approval. This statutory protection will operate to preserve the Commission's jurisdiction over the utilities' assets for the benefit of the rate-paying customers.

The OAG is not so optimistic with respect to Commission jurisdiction in the context of an Aquila bankruptcy. The Bankruptcy Code (11 U.S.C. § 101 et seq) and recent case law operate against the application of state statutes such as § 215B.50.^{3 4}

³ It is important to note that 11 USC § 1129(a), which specifies the conditions precedent for approval of the plan by the bankruptcy court, provides that state public utility commissions retain regulatory authority over ratemaking, even in bankruptcy:

(a) 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.

⁴ To illustrate the enormous sweep of the power of the Bankruptcy Code, see *In re Good Time Charlie's Ltd.*, 25 B.R. 226 Bankr. (E.D.Pa., 1982), holding that a shopping mall, which supplied electricity to a bankrupt restaurant in the mall, was a "utility" within the meaning of the Bankruptcy Code and therefore could be enjoined from discontinuing the debtor-restaurant's (Footnote Continued on Next Page)

II. THE RECENT PG&E BANKRUPTCY ORDER RULES THAT ALMOST ALL STATE REGULATORY AUTHORITY IS PREEMPTED BY THE BANKRUPTCY COURT.

On April 6, 2001, PG&E filed a voluntary petition under Chapter 11 of Title 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Northern District of California. On February 7, 2002, the bankruptcy court issued its Memorandum Decision and on March 18, 2002 its Order regarding preemption and sovereign immunity, rejecting PG & E's "across-the-board, take-no-prisoners" claim that § 1123(a)(5) allows it to "disaggregate with unfettered preemption of any contrary nonbankruptcy law." Bankr. Dec. (ER 863) at 46, 40. PG&E appealed the bankruptcy court's decision to the United States District Court for the Northern District of California. The latter court's recent bankruptcy ruling from August 30, 2002, in a major victory for Pacific Gas & Electric Co. ("PG&E"), established that federal bankruptcy law overrides any state law that interferes with the utility debtor's proposed reorganization, thus ending most state regulation of the company.⁵ PG&E wishes to transfer its power plants and transmission systems to newly created companies that would fall under the authority of the Federal Energy Regulatory Commission ("FERC"). The properties would then be used as collateral to repay PG&E's \$13 billion in debts. The issue of whether a bankruptcy plan pre-empt's state law is a crucial issue in this case, as PG&E's plan conflicts with numerous California laws. One such law that took effect last year prohibits California utilities from selling or transferring power plants until 2006. An earlier state law requires CPUC approval for sales of utility assets, similar to Minn. Stat. § 216B.50. The CPUC contends PG&E would also need

(Footnote Continued From Previous Page)

electrical service notwithstanding fact that it had terminated debtor's electrical service prior to the debtor's filing for bankruptcy under Chapter 11.

⁵ See *In Re: Pacific Gas and Electric Co.*, 283 B.R. 41 (N.D.Cal., August 30, 2002).

environmental review under state law before transferring the land around its hydroelectric plants.⁶

In overruling the Bankruptcy Court's ruling that PG&E could not automatically preempt state laws that got in the way of its plan, the Federal District Court noted that provisions of the 1984 federal bankruptcy law showed that Congress intended to pre-empt any law impeding transactions necessary to implement the reorganization plan. The Court also noted that state commissions, which formerly held veto power over utility bankruptcy plans, were limited by Congress in 1978 to ruling on rate increases caused by the plans. The Court found it was Congress' intent that public utilities no longer be subject to the costs, delays and uncertainty of state approval of their reorganizations.⁷ The Court further reasoned that its holding is consistent with the few other rulings that exist on the scope of 11 U.S.C. § 1123(s)(5):

As noted, every court except the bankruptcy court below to have considered § 1123(a)(5) has concluded that this section contains an express preemption of nonbankruptcy laws that would otherwise apply to the restructuring transactions provided for in a reorganization plan. The case law on this subject is, however, rather limited. By far, the court to have considered this matter in the most depth is the United States Bankruptcy Court for the District of New Hampshire in *Public Service Company of New Hampshire v New Hampshire (In re Public Serv. Co)*, 108 B.R. 854 (D.N.H.1989). After conducting a quite helpful and thorough analysis of the (again rather limited) legislative history of § 1123(a), the New Hampshire bankruptcy court concluded that the meaning of § 1123(a)(5) is clear:

With regard to the present statutory provision before the court, i.e. § 1123(a)(5) providing that "notwithstanding any otherwise applicable nonbankruptcy law" a plan of reorganization "shall" contain adequate provisions for the plan's implementation, in terms

⁶ It should be noted that not only is the issue of state public utility regulation at stake, but the United States Environmental Protection Agency weighed in the PG&E case because an approved bankruptcy plan could override even other *federal* statutes, such as environmental laws that would otherwise bar transactions necessary to implement the reorganization plan.

⁷ The CPUC is in the process of appealing Walker's Order, and the OAG has learned that Oregon may take the lead in organizing efforts to coordinate other states in filing an amicus brief.

of the necessary restructuring of the debtor and its assets and liabilities common to all plans of reorganization in complex cases, the statute would seem to be plain on its face to indicate an express preemptive intent as to such restructuring provisions of a Chapter 11 plan of reorganization. *Id.* at 882.

Pacific Gas and Electric 283 B.R. at 48. Although *In re PG&E* is only a district court reversal of a bankruptcy order in another federal Circuit, so that even if it stands up on appeal to the Ninth Circuit it will have no controlling effect on rulings pertinent to Minnesota public utilities (unless it is ultimately upheld by the United States Supreme Court), because of the paucity of case law regarding public utility bankruptcies, there is no doubt it will be looked to by courts in all venues dealing with this issue. In the words of the overruled bankruptcy court:

This is a Chapter 11 case of enormous significance to thousands of creditors owed billions of dollars. It is clearly one of the largest bankruptcies in United States history, and definitely the largest involving a public utility. An attempt by a utility to free itself from state regulation to the extent contemplated by the Plan is virtually without precedent. Bankr. Order (ER 924) at 5-6.

The CPUC has filed a Motion for Stay Pending Appeal of the State of California and Others to the United States Court of Appeals for the Ninth Circuit.⁸ Without a stay, appeal to the Ninth Circuit could be dismissed as moot if PG&E swiftly implements its proposed plan. The CPUC argues that 11 USC § 1123(a) does not expressly preempt all state and federal law applicable to a Chapter 11 restructuring, and that the Bankruptcy Code contains a presumption against preemption overall.

⁸ Motion for Stay Pending Appeal of the State and Others, *In Re: Pacific Gas and Electric Company*, Case No. C 02-01550 VRW, U.S. District Court (October 8, 2002, N.D.Cal.).

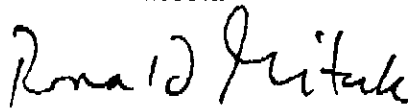
CONCLUSIONS

The OAG submits that if Aquila, Inc. were to file for protection under the bankruptcy laws, contrary to Aquila's assertions, the Commission's authority under Minn. Stat. § 215B.50 governing the transfer of public utility assets may be preempted by the bankruptcy court. In addition, except for its express authority in the Bankruptcy Code to approve changes in rates, the Commission and, indeed, all other state and federal regulatory agencies could be rendered virtually powerless with respect to the regulation of a bankrupt public utility.

Dated: November 1, 2002

Respectfully submitted,

MIKE HATCH
Attorney General
State of Minnesota



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AG: #752811-v1

AFFIDAVIT OF SERVICE BY U.S. MAIL

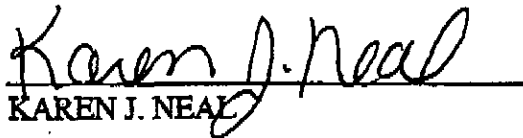
Re: *In the Matter of Peoples Natural Gas and NMU Inquiry into Possible Effects of Financial Difficulties at Aquila*
MPCU Docket No. G007,011/CI-02-1369

STATE OF MINNESOTA)
) ss.
COUNTY OF RAMSEY)


KAREN J. NEAL, being first duly sworn, deposes and says:

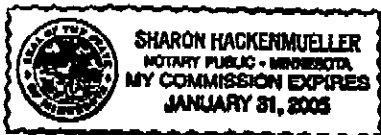
That at the City of St. Paul, County of Ramsey and State of Minnesota, on November 1, 2002, s/he caused to be served the **REPLY COMMENTS OF THE OFFICE OF THE ATTORNEY GENERAL**, by depositing the same in the United States mail at said city and state, true and correct copy(ies) thereof, properly enveloped with prepaid first class postage, and addressed to:

See Attached Service List


KAREN J. NEAL

Subscribed and sworn to before me on
November 1, 2002


NOTARY PUBLIC



SERVICE LIST

Re: In the Matter of Peoples Natural Gas and NMU Inquiry into Possible Effects of
Financial Difficulties at Aquila
MPUC Docket No. G007,011/CI-02-1369

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AG: #752347-v1



STATE OF MINNESOTA

OFFICE OF THE ATTORNEY GENERAL

MIKE HATCH
ATTORNEY GENERAL

November 1, 2002

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Executive Secretary
MN Public Utilities Commission
121 East Seventh Place
Suite 350
St. Paul, MN 55101-2147

MICHAEL J. BRADLEY

Re: *In the Matter of Peoples Natural Gas and NMU Inquiry into Possible Effects of
Financial Difficulties at Aquila*
MPCU Docket No. G007,011/CI-02-1369

Dear Dr. Haar:

Enclosed for filing, please find the original and 14 copies of the Reply Comments of the Office of the Attorney General in regard to the above-referenced matter, along with the Affidavit of Service.

If you have any questions, please feel free to contact me at the number listed below.

Sincerely,

RONALD M. GITECK
Assistant Attorney General

(651) 284-4066

Enc.

cc: See Attached Service List

AG: #752371.v1