Exhibit No.:	
Issues:	*Capital Structure; Insulation & Ring-fencing*
Witness:	*Ronald L. Bible*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Rebuttal Testimony*
Case No.:	*EF-2003-0465*
Date Testimony Prepared:	*September 10, 2003*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

RONALD L. BIBLE

AQUILA, INC.

CASE NO. EF-2003-0465

Jefferson City, Missouri
September 2003

****Denotes Highly Confidential Information****

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BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Application of Aquila, Inc. for Authority to Assign, Transfer, Mortgage or Encumber Its Franchise, Works or System	)))	Case No. EF-2003-0465

AFFIDAVIT OF RONALD L. BIBLE

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Ronald L. Bible, being of lawful age, on his oath states: that he has participated in the preparation of the following Rebuttal Testimony in question and answer form, consisting of 19 pages to be presented in the above case; that the answers in the following Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Ronald L. Bible

Subscribed and sworn to before me this 9th day of September 2003.

TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004

TABLE OF CONTENTS

RONALD L. BIBLE

AQUILA, INC.

CASE NO. EF-2003-0465

REBUTTAL TESTIMONY

OF

RONALD L. BIBLE

AQUILA, INC.

CASE NO. EF-2003-0465

Q. Please state your name, occupation and business address.

A. My name is Ronald L. Bible. I am employed by the Missouri Public Service Commission (MoPSC) as the Manager of the Financial Analysis Department. My business address is 200 Madison Street, Jefferson City, Missouri 65102.

Q. Please describe your educational and professional background.

A. In 1981, I earned a Master of Business Administration degree with an emphasis in Finance and Investments from the Southern Illinois University at Edwardsville, Illinois. In 1976, I earned a Bachelor of Arts degree in Social Science from Colorado State University, Ft. Collins, Colorado.

Q. What is your work experience?

A. I was employed by Credit Union National Association from 1995 to 1997 and by American Express from 1991 to 1995 as a Financial and Investment Analyst/Planner. Prior to that, I was with Voluntary Hospitals of America and Hospital Corporation of America where I performed statistical and financial analysis. Previous to these positions, I was an officer in the United States Air Force and was responsible for a unit that provided statistical analysis.

Q. Have you previously filed testimony before this Commission?

A. Yes. I filed testimony in the following cases:

Case No.	Company	Issue
GR-98-140	Missouri Gas Energy	Rate Of Equity / Rate Of Return
GF-98-425	Southern Union	Non-control Investments
EC-98-573	St. Joseph Light & Power	Rate Of Equity / Rate Of Return
ER-99-247	St. Joseph Light & Power	Rate Of Equity / Rate Of Return
RP99-485-000	Kansas Pipeline Co.	Rate Of Equity / Rate Of Return
GM-2001-342	Laclede Gas Co.	Reorganization Conditions
EC-2002-1	AmerenUE	Rate Of Equity / Rate Of Return

Q. Have you made recommendations in any other cases before this Commission?

A. Yes, I have made recommendations on finance, merger and acquisition cases before this Commission.

Q. Did you make an examination of the request from Aquila, Inc. (Aquila, Company) in this case?

A. Yes.

Q. What did you rely on to conduct this examination?

A. In addition to my experience, I relied upon the Company's application and attached documents, the Company's proposed restructuring plan, financial statements and telephone interviews with the Company's representatives.

Q. What is the purpose of your rebuttal testimony in this case?

A. The purpose of my rebuttal testimony is to respond to portions of the Direct Testimony of Mr. Jon R. Empson and Mr. Rick Dobson that address capital structure and insulation and "ring-fencing." Their testimony was filed in support of the Company's application to encumber and use Missouri's regulated utility assets as collateral for working

capital loans. The Company's use of Missouri's regulated utility assets as collateral for the loans is part of its financial restructuring plan.

Q. How does a utility company acquire working capital?

A. Usually, when a stand-alone investor owned utility company determines it has a need for working capital that is in excess of what it has in its treasury or can generate from its operations, it will negotiate with an outside lender to provide the additional funds.

Q. How do Missouri's regulated utilities acquire working capital?

A. Missouri has a combination of stand-alone investor owned utilities, as well as regulated utilities that are subsidiaries and operating divisions of a parent company. In the case of Aquila, Aquila Networks-MPS and Aquila Networks-L&P are two of its operating divisions. As such, they do not issue any of their own capital; instead, they rely solely on Aquila for any capital needs, including working capital. In fact, Aquila Networks-MPS and Aquila Networks-L&P do not even have the capability to retain any of their own earnings to fund their financial needs because all of their receipts or ratepayer payments go directly to Aquila's lockbox account. This money is commingled with other monies, including proceeds from debt issuances and asset sales. The money in this account is available for non-regulated operations as well as regulated utility disbursement.

Q. Given Aquila's financial condition, what assurances does the Commission have that adequate funds will be available in Aquila's treasury for Aquila Networks-MPS and Aquila Networks-L&P when they need working capital?

A. The Company claims that its use of an allocated capital structure and allocated debt costs provides adequate protection, and that its use of an allocated capital structure and

allocated debt costs insulates and ring-fences the regulated utilities from the other activities of Aquila.

Q. Do these safeguards ensure that adequate working capital will be available for Aquila Networks-MPS and Aquila Networks-L&P?

A. These safeguards do not ensure Aquila Networks-MPS and Aquila Networks-L&P will have access to adequate working capital. I will show in my testimony that not only does what the Company propose not provide adequate protection, but that the protections it claims exist, do not. I will also explain the negative consequences that Aquila's situation will have on ratepayers.

Capital Structure

Q. What does Aquila propose for capital structure in this case?

A. The Company proposes to use an allocated capital structure, with allocated costs of debt. The debt cost will be based on the interest paid on debt rated 'BBB' by Standard and Poor's. The Company claims this will provide protection for ratepayers from the increased borrowing costs associated with Aquila's current financial condition.

Q. What is the allocated capital structure Aquila refers to?

A. It is a capital allocation process that Mr. Empson claims the Company has used since 1988. The regulated operating units allegedly receive capital based on what the Company claims a comparable utility would receive. Mr. Empson claims the Company has done a study to determine the typical capital structure for comparable utilities and uses the study results to determine how to allocate capital to its operations. The Company then allocates the capital to the operating units or divisions, such as Aquila Networks-MPS and Aquila Networks-L&P. Mr. Empson uses the terms "hypothetical" and "allocated"

interchangeably. However, they are different and should not be confused. A hypothetical capital structure is a capital structure different than the entity's actual capital structure, and is usually derived from an analysis using a group of comparable companies. By contrast, an allocated capital structure is the capital structure a parent company would impute on or assign to an operating unit subsidiary or division. The allocated capital structure may be based on a hypothetical capital structure analysis, or it may be based on what the parent decides is the capital structure they want to allocate, or a combination of these methods.

Q. Does Aquila state why it proposes an allocated capital structure?

A. Yes. In his direct testimony in this case, Mr. Empson claims that the purpose of the allocated capital structure, since its adoption in 1988, was to insulate and separate each of its utility divisions from the other activities of Aquila and to ring-fence the utility operations from the non-utility business. Again, he uses the terms "insulation" and "ring-fencing" interchangeably. These terms have different meanings. I will address both of them.

Q. Does the allocated capital structure used by Aquila offer protection to utility customers, as the Company claims?

A. No. All the allocation process does is fix the amount of debt and equity used to set rates. At best, it only incorporates in the rate setting process, a specified amount of debt and equity capital and the costs of the capital when rates are calculated. When I address insulation and ring-fencing later in my testimony, I will point out why the allocated capital structure does not provide adequate protection for utility customers and why it is inadequate for keeping the utility operations separate from the non-utility operations.

Q. Does the Missouri Public Service Commission Staff agree with Aquila's use of an allocated capital structure for ratemaking purposes?

A. No. In his direct testimony, Mr. Empson refers to THE divisional or hypothetical capital structure (meaning the Company's allocated capital structure) as being acknowledged by regulatory commissions as an effective way to separate utility operations from non-utility operations. He includes in his support of this claim an excerpt from the Missouri Public Service Commission Staff Report on Aquila, Inc. However, the comments in that report refer to a hypothetical capital structure, not the allocated capital structure used by the Company. Furthermore, the comments in the Staff report are applicable only in the context of using a hypothetical capital structure in a rate case, and are not applicable to sheltering or separating utility from non-utility operations or protecting utility customers from the other activities of Aquila.

Q. What has been the Commission's position on Aquila's allocated capital structure?

A. It has been the position of this Commission that the Company's allocated capital structure is not the appropriate capital structure to use for setting rates for the Company's Missouri utilities. Instead, the Commission has ruled that the appropriate capital structure to use for establishing rates is the consolidated capital structure for the entire Company. In its Report and Order for Case No. ER-90-101, a fully adjudicated rate case involving Aquila before it changed its name, the Commission stated:

> The Commission determines that the capital structure proposed by Staff / Public Counsel, as modified hereinafter, should be adopted in this case…… The Commission finds it is more reasonable to use the consolidated capital structure for MPS than it is to assign a hypothetical capital structure to MPS. As noted by Staff / Public Counsel, MPS has no capital structure of its own and its stock is not traded on the stock market. Investors cannot invest in MPS but can invest in Utilicorp. It is the capital structure of Utilicorp that prospective investors will examine when contemplating an investment.

> It is Utilicorp which must attract capital for the use of its divisions and subsidiaries including MPS.

In this case, the Commission made it clear that it believes the use of an allocated capital structure as proposed by the Company is not the appropriate capital structure to use for ratemaking purposes. It is also clear that the Commission believes the use of a consolidated capital structure is the appropriate capital structure to use for ratemaking purposes, particularly when the regulated operation does not issue its own capital and the company does issue capital for use by the regulated operations.

It is also important to note that the Commission introduced the concept of a capital structure modification or adjustment for future rate cases. In the same case the Commission went on to say:

> The Commission determines that the use of a consolidated capital structure will not, per se, expose MPS's ratepayers to any adverse consequences arising from Utilicorp's other activities any more than the use of a hypothetical, assigned capital structure will insulate them from these consequences…. However, an adjustment would need to be made in future rate cases should Utilicorp develop a capital structure that would subject MPS's ratepayers to adverse consequences arising from Utilicorp's other activities.

The Commission is saying that the use of a consolidated capital structure produces no intrinsic harm to the ratepayer, and the use of an allocated capital structure, as proposed by the Company, does not insulate the ratepayer from the other activities of the Company. The Commission also recognized that the Company's actual consolidated capital structure could develop, as a result of other activities, to the extent that it would have adverse consequences on ratepayers. In that situation, the Commission determined it would be appropriate to make modifications or adjustments. This is exactly the kind of scenario the Staff was referring to in its comments in the Missouri Public Service Commission's Staff Report on Aquila, Inc.

Taken in their proper context, the Staff's comments regarding use of a hypothetical capital structure were meant to address the changes in capital structure the Commission anticipated in its Report and Order for Case No. ER-90-101, and not as an agreement of the Company's use of an allocated capital structure.

In Case No. ER-93-37, a partially settled rate case involving Aquila before it changed its name, the Staff submitted a brief to the Commission in support of the stipulation in that proceeding. The brief did not specifically address the issue of capital structure. Therefore, the Commission did not have all the information necessary to support the use of the parent company consolidated capital structure.

In its Report and Order for another rate case involving Aquila before it changed its name, Case No. ER-97-394, a fully adjudicated rate case, the Commission stated:

> Based on substantial evidence of record, the Commission finds that the consolidated capital structure as proposed by the Staff accurately reflects the correct capital structure of Utilicorp itself, and therefore MPS, during the actual test year.

The record is clear that, when presented with all the information, the Commission precedent is to use the consolidated capital structure for ratemaking purposes. Aquila Networks-MPS and Aquila Networks-L&P are operating divisions of Aquila (Utilicorp), not separate corporate entities, and they do not issue their own capital. All capital needs for Aquila Networks-MPS and Aquila Networks-L&P are provided by Aquila. The Commission has also made clear its belief that the Company's use of the consolidated capital structure does not expose Aquila Networks-MPS and Aquila Networks-L&P customers to any adverse consequences that arise from the Company's other activities. On the other hand, the Commission has determined that the use of an allocated capital structure, as the Company proposes, does not protect ratepayers from those consequences arising from

the Company's other activities. Finally, the Commission recognizes that the Company's capital structure can change over time to the extent that it would expose the ratepayers of Aquila Networks-MPS and Aquila Networks-L&P to adverse consequences arising from the Company's other activities. In that case, the Commission has determined that it would be appropriate to modify the capital structure. This is what the Staff proposed in the Missouri Public Service Commission's Staff Report on Aquila, Inc.

Insulation and Ring-fencing

Q. What is the Company's proposal for insulation and ring-fencing in this case?

A. In his testimony, Mr. Empson claims that the purpose of the allocated capital structure, since its adoption in 1988, was to insulate and separate each of its utility divisions from the other activities of Aquila and to ring-fence the utility operations from the non-utility business. This would, he claims, protect ratepayers from adverse developments in the other activities of the Company. Again, he uses the terms insulation and ring-fencing interchangeably. Although they are related terms, they are not the same. I will clarify these terms later in my testimony. I will also show why insulation and ring-fencing do not exist at Aquila and its operations, and therefore, why ratepayer protections do not exist. I will also explain what consequences are present for ratepayers as a result of the Company's financial situation, and why the Commission should not approve the Company's application in this case. In order to understand the nature of the problems facing the Company's regulated utilities, one must be aware of the business and financial risk posed by Aquila's present situation.

Q. Would you define business and financial risk?

A. Yes. Business risk is the risk associated with the nature of business and the operations of the firm. Financial risk is the risk associated with a firm's sources of financing and its use of leverage. Leverage is the amount of debt and fixed charges the business incurs. Insulation and ring-fencing measures can have the effect of minimizing or eliminating the transfer of these risks from the non-regulated to the regulated operations of a company.

Q. Please explain insulation and ring-fencing.

A. Insulation is a series of measures or conditions that, when implemented by a company, can have the effect of separating the credit quality of the operation where the measures or conditions are implemented from the credit quality of the parent company. Insulation acts to distance the operation from its parent by varying degrees. If sufficient measures or conditions are implemented, it can result in the operation being considered ring-fenced from the parent. The result would be acknowledgement by credit rating agencies, such as Standard and Poor's, that sufficient measures are in place to warrant assignment of a different, potentially higher, credit rating for the operation than for the parent.

Q. Why are these insulating conditions necessary?

A. In the absence of insulating and/or ring-fencing conditions, the business risk and financial risk of the non-regulated operations will be transferred to the regulated utility. This will increase the cost of capital for the regulated utility with no offsetting benefit to the ratepayer. Increasing the cost of capital will result in a detriment to the ratepayer. It will also expose the regulated operation to the bankruptcy risk of the non-regulated operations. Standard & Poor's assumes that an entity's creditworthiness reflects not only its own business and financial profile, but also its relationships with other corporate family members. Therefore, Standard & Poor's will assign a consolidated credit rating, which will include the

operating and financial characteristics of the regulated entity, the non-regulated holding company and the non-regulated subsidiaries.

Q. What will be the effect of this consolidated rating?

A. Standard & Poor's, as well as other credit rating agencies, view the regulated utility operations as being more stable than the non-regulated operations. Therefore, the consolidated credit rating will be lower due to the less stable non-regulated operations. Without insulating and/or ring-fencing conditions, the credit rating of the regulated utility will be no higher than the consolidated credit rating.

Q. How will this be detrimental?

A. With a lower credit rating, the debt of the regulated utility will be issued at a higher cost. Debt purchasers will expect a higher interest payment to induce them to assume the increased risk associated with buying debt with lower credit quality. Also, the increased cost of debt will have the same effect as increasing the total amount of debt outstanding due to higher interest charges. The end result is higher fixed costs. With higher fixed costs, common equity holders would demand a higher return for assuming the greater risk of buying common equity from an entity with greater fixed charge obligations before dividends can be paid. The overall effect will be an increase in the cost of capital.

Q. What has been the experience in the energy business with regards to insulating factors?

A. The Commission's Financial Analysis Department has researched the experience in the energy business with regards to restructurings and mergers and has determined that credit rating agencies, as well as other public utility commissions, have taken a position on the need for insulating conditions. Standard & Poor's has taken positions and

provided extensive information that indicates its opinion on the relevance of insulating and ring-fencing conditions.

Q. What is Standard & Poor's, and what is its relationship with Aquila?

A. Standard & Poor's is a company that provides opinions on the creditworthiness of the bonds, commercial paper, notes, preferred stock and other financial instruments issued by companies in various industries, including the public utility industry. Standard & Poor's relationship with Aquila is that it provides credit ratings regarding Aquila's financial instruments. Investors rely on these ratings as a means of assessing the ability of a company to meet its financial obligations. This information enables investors to determine the risk and return they can expect to experience with a particular investment.

Q. What information has Standard & Poor's provided related to insulating and ring-fencing conditions?

A. In an article entitled "Behind The Ratings: 'Ring-Fencing' A Subsidiary" in the *Standard & Poor's CreditWeek,* October 27, 1999, Standard & Poor's stated:

> In the past, the mere existence of regulation was given considerable weight when determining the adequacy of protection for the utility's cash flow and assets. However, Standard & Poor's will require a progressively higher standard of evidence that insulation exists as the nonregulated component of a holding company's business becomes greater, and the regulated utility shrinks in absolute and relative size. If it is not clear that insulation exists, Standard & Poor's will assume that it does not. Importantly, the corporate credit ratings of utilities that operate in jurisdictions that do not provide insulation, and where no other insulatory measures exist, will be the same as the consolidated corporate credit rating. Under these conditions, this same rating will also apply to the holding company.
>
> Standard & Poor's analysis of the adequacy of regulatory insulation will focus on barriers erected by state commissions and lawmakers to limit the parent company's ability to access the funds of the utility. Such determinations will be made on a case-by-case basis. The parent's ability may be restricted by disincentives created during

> specific proceedings, such as consideration of mergers or formation of a holding company. The conditions may come in the form of dividend limitations or restrictions, capital structure requirements, or stringent reporting requirements. The more restrictions placed on the parent's access to the cash flow of its utility, the better the opportunity for insulation to be recognized. A demonstrated willingness by state regulators to protect the creditworthiness of the utility is an important consideration. Structural factors will also enhance the value of regulatory rules.

Q. Has Standard & Poor's provided any examples of insulating conditions?

A. Yes. In the "Behind The Ratings: 'Ring-Fencing' A Subsidiary" article in the *Standard and Poor's CreditWeek,* October 27, 1999, Standard & Poor's provided the following as examples of insulating conditions:

> **STRUCTURAL INSULATION**
>
> -Partial ownership of a subsidiary by an outside party,
>
> -Separate boards of directors for each entity (preferably with outside representation),
>
> -Separate management,
>
> -Separate country or jurisdiction,
>
> -Separate name,
>
> -Absence of cross-default covenants, and
>
> -Separate financing activities.
>
> **REGULATORY INSULATION**
>
> -Restrictions on cash flow,
>
> -Restrictions on debt as a percentage of capital,
>
> -Restrictions on dividends,
>
> -Debt rating targets established by a commission,

-Limitations on the amount of investment in nonutility businesses, and

-Limitations on the types of investments that a utility or holding company can make.

In the article Standard and Poor's also indicated that in appropriate circumstances, a ratings enhancement package may be sufficient to raise the credit quality of a subsidiary above that of the consolidated entity. The enhancement package should include:

-Structure, such as special purpose entity or limited purpose entity, collateral agent control of cash;

-Covenants, such as dividend tests, negative pledges, non-petition covenants, prohibitions on creating new entities, restrictions on asset transfers and inter-company advances;

-Pledging of collateral, subsidiary's pledge of assets to collateral agent or security trustee, and parent's pledge of its ownership interest.

Q. Does Aquila have any of these conditions in place?

A. No. During a telephone interview with Company representatives on July 16-18, the Staff asked Mr. Dobson and Mr. Empson a series of questions addressing the above conditions as they applied to Aquila and its operations. None of the conditions or measures identified by Standard and Poor's were in place to provide any form of insulation or ring-fencing. It is also interesting to note that when I asked if a division could be insulated, Mr. Dobson replied "no." Therefore, even though Mr. Empson claims in his testimony that it was their intention all along, since 1988, to insulate and ring-fence the regulated from the non-regulated operations, they know that under their existing structure and organization it can't be done. It is important to note that of the conditions and measures

indicated by Standard and Poor's as being required for consideration of insulation or ring-fencing, Aquila's allocated capital structure and imputed cost of debt are not included. In other words, Standard and Poor's does not recognize an allocated capital structure and/or imputed cost of debt as a means of insulating or ring-fencing regulated operations from non-regulated operations.

Q. Are there examples of utility operations that have been considered insulated?

A. Yes. In its report, *Utility Ratings For The Changing Times,* November 1998, Standard and Poor's considered Kern River Gas Transmission Co., wholly owned by The Williams Cos., to be insulated to the extent that it was considered to be on a stand-alone basis and not affected by the parent's credit quality. In its *Utilties and Perspectives,* August 4, 2003, Standard and Poor's stated that PPL Electric Utilities Corp. (PPLEU) was sufficiently insulated from its parent, PPL Corp. (PPL) to warrant rating PPLEU on a stand-alone basis and assigning it a two notch higher credit rating than PPL.

Q. Are there any examples of a utility's non-regulated operations negatively affecting their regulated operations?

A. Yes. Western Resources (Western) is a consumer services company based in Topeka, Kansas. Western's business operations include generation, transmission, distribution and sales of electric energy in Kansas, and interests in unregulated monitored services. In its December 31, 2000, Form 10K filed with the Securities and Exchange Commission, Western stated that its monitored services have had a history of losses and that it expects these losses to continue. Western went on to say that credit rating agencies are applying more stringent guidelines when rating utility companies due to increasing competition and utility investment in non-utility businesses. Standard & Poor's,

June 6, 2000, *Ratings Direct* for Western Resources stated that Western faced significant challenges and uncertainty because of its extremely weak financial condition.

Western expanded largely by acquisitions financed with debt. These debt financings placed significant pressure on its balance sheet and resulted in lower creditworthiness. Western's financial flexibility was unusually weak for a highly regulated utility company. Western had to make amendments to credit lines that Standard & Poor's said would increase its cost of borrowing.

Another example is Tucson Electric Power (TEP). The Arizona Commission placed 32 insulating conditions on TEP as a result of its request to form a holding company. TEP is an Arizona corporation providing electric service to the public within portions of Pima and Cochise Counties, Arizona. The Arizona Commission, in its Opinion And Order dated February 22, 1996, for Docket No. U-1933-95-069, stated that during the 1980's time period, TEP diversified into non-utility areas that did well for a while. However, most of the diversified areas turned sour toward the end of the 1980's. As a result of the aforementioned diversification, as well as a spin-off to market TEP's excess capacity, TEP reached a point in the early 1990's where it simply could not pay all of its bills. On July 16, 1991, a group of owner participants filed Involuntary Petitions for reorganization of TEP under Chapter 11 of the U.S. Bankruptcy Code.

Q. Why doesn't the Company's proposed allocated capital structure and debt cost provide adequate protection for ratepayers?

A. The Company wants to give the Commission the impression that approval of its application in this case will produce no harm to ratepayers and that adequate ratepayer protections can be implemented in a rate case by adopting its allocated capital structure and

debt cost. The Company proposes to allocate capital based on a capital structure report that hasn't been updated since 1988, and allocating debt cost at a rate equal to debt rated 'BBB' by Standard and Poor's. Aquila's attempt to focus attention on ratepayer protections into a rate case, detracts from the need to recognize the harm to ratepayers not covered in a rate case.

According to the financial restructuring plan submitted by the Company, it intends to return to a purely domestic utility. Its proforma financial statements show financial projections through 2005. The Capital Allocation Process in the plan reflect ** HC ** billion in regulated utility debt and ** HC ** billion non-regulated debt. Presently, Standard and Poor's has Aquila rated 'B' with a negative outlook, and in its July 9, 2003, research summary, had this to say:

> The negative outlook reflects uncertainties regarding the timely execution of Aquila's future asset sales, the level of debt reduction from asset sale proceeds, and the company's ability to restructure its tolling commitments and gas prepay contracts. The ratings could fall further if Aquila is unable to execute asset sales, significantly reduce debt leverage, and stabilize credit measures within the next 9 months. Maintaining the ratings is dependent on Aquila's ability to restructure its business successfully, develop a new tolling strategy, and attain additional cost reductions.

Standard and Poor's is indicating in its research comments on Aquila that for the Company to maintain its current 'B' rating, it must successfully implement its plan, and failure to do so could result in further downgrades. This means that even if Aquila is successful in implementing its plan, it will end up as a vertically integrated electric utility, with a below investment grade rating and ** HC ** billion of non-regulated debt. The only source of income to service the non-regulated debt is the regulated utility ratepayers.

According to Standard and Poor's report *Downside Rating Trend Continues For U. S. Utilities In First Quarter,* April 24, 2003, a vertically integrated utility should be able to

maintain an 'A-' average rating. Aquila has stated its goal is to allocate debt at the rate of a 'BBB' rating or two notches lower than A-. Moody's Bond Record indicates the average coupon on newly issued utility bonds for Moody's 'A' rated utilities was 6.92 percent and for Moody's 'Baa' rated (Standard and Poor's BBB equivalent) utilities was 7.35 percent for the 12 months ended June 2003. Assuming a linear relationship and a similar coupon spread from Moody's 'Baa' (Standard and Poor's BBB) to Moody's B2 (Standard and Poor's B), the difference in debt interest is 43 basis points. Based on this difference, any requirement to refinance just the non-regulated debt would result in additional interest charges for the Company of ** HC ** million. The difference from Aquila's current credit rating and where Standard and Poor's says an average credit rating for a vertically integrated utility should be is 115 basis points, resulting in additional interest charges on the non-regulated debt of ** HC ** million. Furthermore, this does not include any additional interest expense that may be incurred from any required refinancing of the regulated debt. The only source of revenue and earnings that will be available to service this debt are the regulated utility ratepayers.

Q. How does the Company propose to take care of this debt?

A. The Company proposes to issue more common equity. At first glance, that may seem like a reasonable alternative. The Company issues more common stock, pays off the non-regulated debt and moves its credit rating higher and gets a lower interest charge on its debt. However, a closer examination reveals some flaws in this alternative. Given the Company's situation, what investor(s) would buy common stock in the Company? As the Company transforms itself back to a vertically integrated electric utility that means it is no

longer growth oriented. In addition, it doesn't pay a dividend. Where does the return for an investor come from?

Aquila's stock has traded around $2.50 per share for the last couple of months. To pay off ** HC ** billion in debt cost from equity issuance proceeds means Aquila would have to issue over 450 million additional shares at $2.50 per share. According to Aquila's 2002 annual report, the number of Aquila common shares outstanding is 194 million. This means Aquila would have to issue over twice as many shares as it currently has outstanding and at the current average price. It is highly unlikely the market would absorb this.

Even if the Company could sell the number of shares necessary at this price, paying off non-regulated debt with the proceeds of common equity issuance does nothing more than shift the cost of non-regulated capital from debt to equity. It does not make it disappear. Ratepayers will still be paying the cost of non-regulated capital. So, even if you develop rates in a rate case and exclude certain things, or allocate a certain capital structure and cost of debt, the revenue generated still goes to servicing non-regulated capital with no benefit to the regulated utility ratepayers.

Q. Does this conclude your rebuttal testimony?

A. Yes.