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Diversified Utility Comparison: Aquila Inc. and Allegheny Energy Inc.

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Aquila Inc. and Allegheny Energy Inc. have 'B' corporate credit ratings with negative outlooks. Ratings at this level often reflect vulnerable financial profiles and businesses that are in a transitional phase. Credit deterioration for these issuers is largely a result of debt-financed expansion into riskier, unregulated lines of business. Although these issuers have made recent progress toward stemming their deteriorating credit profiles, significant challenges remain in improving their liquidity to meet sizable near-term obligations. Ratings at the 'B' level indicate situations in which credit profiles are susceptible to further deterioration and, ultimately, some form of financial restructuring. Liquidity is the key credit concern at this rating level.

Downside risk and volatility associated with energy trading and marketing, as well as Aquila's and Allegheny's merchant energy operations, overwhelmed the stable portion of cash flows associated with their regulated utility businesses. The management teams and organizational structure were incapable of managing risks associated with energy marketing and trading (EM&T), as well as merchant energy operations. Although challenging market conditions brought these issues to the fore, the business models were deeply flawed from the onset of the implementation of the strategies. As a result, Allegheny and Aquila have seen the financial shortfalls of their nonregulated subsidiaries negatively affect their consolidated corporations' creditworthiness.

Still, both issuers' longstanding utility operations are of meaningful scale and scope. The management teams espouse the mantra of a "back-to-basics" strategy, and the regulated utility represents the core business operation for these entities. It is noteworthy that the regulated utility businesses possess characteristics that would merit an investment-grade business profile on a stand-alone basis.

Certainly, deteriorating credit quality in this sector, as well as ill-conceived strategic decisions, is not new. However, it is unusual to have ratings at the 'B' level for diversified utility companies with considerable regulated operations. When comparing the business and financial profiles, some relevant differences and similarities can be observed. Both companies have experienced significant credit erosion and subsequent ratings downgrades over the past year (see table 1). In addition, financial shortfalls of their nonregulated subsidiaries negatively affect the consolidated companies' creditworthiness.

Table 1 Corporate Credit Rating History	
Aquila Inc.	
Rating	**Rating date**
B/Negative/--	April 11, 2003
B+/Watch Neg/--	Feb. 25, 2003
BB/Negative/--	Nov. 19, 2002
BBB-/Negative/A-3	Sept. 4, 2002
BBB/Watch Neg/A-2	April 30, 2002
Allegheny Energy Inc.	
Rating	Rating date
B/Negative/--	May 8, 2003
BB-/Watch Neg/--	Jan. 16, 2003
BB/Watch Neg/--	Oct. 9, 2002
BBB/Negative/A-3	Aug. 16, 2002

BBB+/Stable/A-2	April 4, 2002
A/Watch Neg/A-1	Feb. 19, 2002

These issuers are among the lowest-rated entities in the utility sector. Both have marginal liquidity profiles, are highly leveraged, and have credit ratings that are vulnerable to any adverse business or financial circumstances (see table 2).

Table 2 Ratings Factors Leading to Recent Downgrades	
Allegheny	**Aquila**
Poor financial performance	Weak cash flows from operations
Limited financial flexibility	Execution risk with future asset sales
Weak business profile due to risky trading operations	Limited financial flexibility
Failure to provide timely disclosures to the SEC	Sizable debt maturities in 2004
Sizable debt amortizations in 2004	Tolling and gas prepay commitments
	Working capital needs in 2003 to 2004

Both issuers have found it more difficult to exit noncore businesses without adverse financial repercussions. The companies are focused on returning to the core utility businesses and rationalizing noncore business operations.

Nevertheless, there are clear differences in their credit profiles:

- The extent of exposure to noncore unregulated business lines is greater for Aquila than Allegheny.
- Aquila's core regulated utility operations and associated cash flows are considerably smaller, roughly about one-fourth of Allegheny's. Therefore, Aquila could have greater volatility in financial performance over the intermediate term.
- Aquila has greater execution risk associated with asset sales and extricating itself from financially unfavorable, long-term contractual agreements.
- Allegheny is likely to have more problematic financial control, and operational and management control issues over the near term. The company has been unable to produce audited financial statements for more than a year and twice this year has revised its forecast 2003 sales and cash flow expectations downward.
- Uncertainty about Allegheny's financial statements is a major ongoing rating concern.
- Although both companies have upcoming liquidity needs, Aquila's 2004 maturities are senior bond maturities, while Allegheny's near-term needs will be bank loan amoritizations, which may be more manageable, through financial renegotiation with lenders, than Aquila's bond maturity.

Prospects for Credit Quality

In the future, both issuers will be challenged to retain or improve credit quality. Allegheny and Aquila have embarked on restructuring strategies aspiring to improve liquidity, decrease nonregulated exposure, and improve their credit profiles.

Allegheny must overcome significant operational and financial challenges to stabilize its credit profile. The company is highly leveraged with almost $5 billion of debt, and faces potential cash drains exiting various business lines. The company also faces considerable near-term bank loan maturities. However, there has been significant progress recently in bolstering its liquidity position, which is perhaps the most important credit consideration at this rating level. Allegheny has:

- Sold its California Department of Water Resources (CDWR) energy contract to Goldman Sachs for $354 million in September 2003.
- Bought out a tolling agreement in August 2003 with The Williams Cos. Inc. for $128 million that was expected to drain $600 million over the next 15 years.

- Terminated its 222 MW tolling agreement with a unit of Black Hills Corp. for a final payment of $114 million in August 2003.
- Issued $300 million in trust-preferred convertible securities in July 2003 to bolster its liquidity position.
- Completed the sale of its 83 MW share of the Conemaugh Generating Station for about $51.25 million in June 2003.

Proceeds from these actions are being deployed to either reduce debt or satisfy existing obligations. Allegheny's significant amortization for the remainder of 2003 is $257 million of bank loan amortization at Allegheny Energy Supply Co. LLC due in December 2003.

Although a clear picture of Allegheny's liquidity is difficult to assess, in the absence of timely financial statements, Standard & Poor's expects that the company will be able to satisfy near-term bank loan amortizations of $257 million in December 2003 with the proceeds from recent asset sales and convertible bond issuance.

After that, Standard & Poor's notes that financial performance for 2003, which has been revised downward throughout the year, and costs associated with either unwinding or exiting various business lines could further diminish liquidity.

The company faces $464 million of bank loan amortizations in 2004.

Aquila faces more difficult execution challenges than Allegheny, as it seeks to return to its traditional regulated utility business model. Whereas Allegheny's asset sales are largely completed, much of Aquila's efforts to stabilize credit quality rely on the execution of further asset sales. The following factors will continue to hamper efforts to improve Aquila's creditworthiness in the near term:

- Commitments under long-term gas delivery contracts and capacity generation contracts will generate significant losses and negative cash flows for an extended period of time.
- Aquila's weak financial condition will limit access to the capital markets, particularly as it relates to debt refinancing.
- A portion of assets is pledged as collateral for loans, also limiting additional financing.
- Nearly $400 million of bonds mature in 2004.

Still, Aquila has managed to sell assets worth more than $3 billion over the past year and has achieved more than $100 million in cost reductions by curbing operational expenses and rationalizing its trading and marketing business. In particular, in September 2003, Aquila agreed to sell its Canadian utility business for nearly $990 million, which is earmarked pay off debt. The company completed the sale of its Australian energy investments for net cash proceeds of about $477 million in July 2003, and will use those proceeds to reduce debt. Aquila has also reduced capital investments in its noncore business units, such as Everest Connections.

The liquidity needs are exacerbated by working capital and collateral needs that could exceed $500 million. In addition, operating cash flow will not likely help liquidity in the near term. This is partially offset by proceeds from nearly $1.4 billion of asset sales that were completed since June 2003. The net proceeds are likely to be considerably less in the case of the sale of its Canadian assets, which had outstanding debt of nearly $300 million.

Table 3 Aquila Inc. Liquidity Profile*	
Mil. $	
Cash	237
Restricted cash	332
Bank lines	0
Capital expenditures (year to date)	139

Maturities	$250 mil. senior notes due July 2004; $150 mil. senior notes due Oct. 2004
*As of June 30, 2003.	

Regulated Businesses

Allegheny possesses the stronger regulated utility business profile due to regulated transmission and distribution businesses, supportive regulatory climate, and favorable service territory economics. Allegheny's utility operations are more than four times as large as Aquila's operations. Allegheny possesses the following:

- Owns or controls 12,327 MW of generation that is 64.01% coal-fired, 26.48% natural gas-fired, 7.79% pumped-storage hydroelectric, 1.25% oil-fired, and 0.47% hydroelectric.
- Delivers electric and natural gas service to about three million people in Maryland, Ohio, Pennsylvania, Virginia, and West Virginia.
- Is a registered utility holding company under the Public Utility Holding Company Act of 1935.

Aquila has a weaker regulated business profile despite sales of most of its nonregulated merchant assets over the past two years and its return to a regulated utility model. The company possesses the following:

- Owns 2,092 MW of generation, of which 54% is coal fired and 46% is gas and/or oil fired.
- Has about 438,000 electricity customers in Missouri, Kansas and Colorado.
- Sells excess power to other utilities and marketing companies.
- Distributes natural gas to about 891,000 customers in Missouri, Kansas, Colorado, Nebraska, Iowa, Minnesota and Michigan.

Table 4 Regulated/Nonregulated Operations Breakdown

	Regulated (domestic)	Regulated (foreign)	Nonregulated (domestic)	Nonregulated (foreign)
Allegheny Inc.	Electric and natural gas utilities	None	Allegheny Energy Supply Co. LLC; Allegheny Ventures	None
Aquila Inc.	Electric and natural gas utilities	Electric distribution in Canada; 79% interest in Midlands Electricity PLC (U.K.)	IPP generation assets; wholesale services; Everest Connections	Wholesale services

Unregulated Businesses

Aquila's and Allegheny's nonregulated operations weigh heavily on business-risk levels. Aquila's nonregulated businesses have a higher risk profile despite efforts to return to its core utility operations. The company was forced to exit the EM&T business in June 2002, which reduced the company's overall risk profile considerably.

Nevertheless, a high level of business risk remains in its unregulated operations as the liabilities of its Aquila Merchant Services business include prepaid natural gas delivery contracts and tolling agreements. The company also has an independent power producer portfolio of 13 generation assets, which it intends to sell in the near term. Aquila also owns a broadband communications business, Everest Connections, that provides local and long distance telephone and cable television service in Kansas City. To conserve cash flow, management has limited its future funding of Everest Connections to levels necessary to complete construction and progress and serve existing customers. Aquila has a majority stake in the British utility Midlands Electricity PLC.

The variability of financial performance is likely to be greater for Aquila in the near term due to the scope of its remaining noncore operations. Aquila's commitments related to its prepaid gas contracts and payments associated with its tolling agreements are problematic. Aggregate cash outflows from these commitments are estimated to exceed $200 million in 2003 and 2004. Capital expenditures are also likely to exceed $150 million in 2004 and also weaken cash flows.

Allegheny's nonregulated business operations have been severely curtailed over the past year. The company has substantially exited its EM&T operations, sold its CDWR contract and bought out various tolling agreements. Still, the company has not released audited financial statements since mid-2002 and therefore Standard & Poor's is unclear about the extent of financial write-downs or charges associated with exiting these businesses. The company's largest remaining nonregulated concern is 1,700 MW of Midwest peaking capacity, which management intends to maintain, although it is unlikely to generate any meaningful cash flow.

Other Factors

Management's ability to execute and implement a successful turnaround strategy can be a crucial factor in determining whether a company's credit profile will improve or fall toward insolvency. Current management faces the formidable task of removing itself from these riskier businesses and managing the balance sheet burdens left by their predecessors.

Allegheny is in the process of revamping its management team with a combination of executives with considerable industry expertise, and executive talent from outside the utility industry. Standard & Poor's views these changes as a modestly positive step, although recognizing that the challenges facing the management team are quite difficult.

Aquila's management team has long historic tenure with the company, and is striving to return the company to its utility roots. Although current management has acted expeditiously in exiting nonregulated businesses, it is also partially responsible for a series of poor investment decisions that led to the precipitous decline in credit quality. In addition, one of management's greatest hurdles will be mending relationships with regulators that were strained during Aquila's expansion into nonregulated businesses.

Allegheny's regulatory challenges are not as significant. However there are ongoing regulatory concerns, such as Allegheny's violation of the SEC debt to total capital ratio requirement, and the lack of audited financial statements since June 2002.

Financial Profiles

The financial condition of both companies over the intermediate term will remain highly leveraged and suffer from weak credit measures. Because Allegheny has not released timely financial statements, it is difficult to compare the financial profiles of both companies. However, based on the historic cash flow generation of Allegheny's core regulated entities and the limited information that the company has released, Standard & Poor's has estimated credit measures for 2003 (see table 5).

Table 5 Estimated 2003 Credit Measures

	FFO to total debt (%)	FFO interest coverage (x)	Total debt to total capital (%)
Aquila	5	1.6	68
Allegheny	12	N.A.	75

FFO--Funds from operations. N.A.--Not available.

In terms of total debt, Allegheny has an estimated $5.8 billion, while Aquila has $2.9 billion.