MINNESOTA
DEPARTMENT OF
COMMERCE

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RECEIVED

AUG 2 0 2003

MICHAEL J. BRADLEY

August 19, 2003

Burl W. Haar
Executive Secretary
Minnesota Public Utilities Commission
121 7th Place East, Suite 350
St. Paul, Minnesota 55101-2147

RE: *Additional Comments* of the Minnesota Department of Commerce
Docket No. G007,011/S-03-681

Dear Dr. Haar:

On April 30, 2003, Aquila, Inc. (Aquila, or the Company) filed its initial request (Initial Request) for,

> approval to encumber Aquila Networks-Peoples and Aquila Networks-NMU Minnesota utility property to secure the payment of a $430 million loan[.]

On June 30, 2003, the Minnesota Department of Commerce (Department) issued its *Initial Comments* (*Comments*) in this matter. On July 15, 2003, Aquila issued its *Reply Comments* (*Reply Comments*) On July 21, 2003, the Minnesota Public Utilities Commission (Commission) issued a formal notice of a fifteen-day *Additional Comment* period. The *Additional Comment* period was extended to August 19, 2003. These comments constitute the Department's *Additional Comments* pursuant to the Commission's notice.

The Department has had a face-to-face meeting with the Company and several phone conversations in order to fully understand Aquila's position. However, these discussions have led the Department to conclude approval of the Company's request would not be in the public interest. Therefore, the Department recommends that the Commission deny the Company's request to encumber Minnesota assets. The Department does appreciate the Company's willingness to meet with the Department and discuss the details of this matter.

The Company's original intent with regards to the Term Loan Facility (TLF) has changed since the Company's April 30, 2003, Initial Request. Aquila's original intent for the TLF, as discussed by the Department on page 8 of its *Comments*, would be to use $180 million of the $430 million TLF to buy back the Company's more expensive outstanding debt The Department protested this use of the TLF as a violation of the separation principle. However, per the Company's *Reply Comments* this would no longer be the case. According to the Company on page 3 of its *Reply Comments*,

> Aquila agrees not to use the encumbered regulated assets in order to use a credit facility to buy back debt that was created by Aquila to pay for its various nonregulated activities. (Emphasis in original.)

On Wednesday, July 30, 2003, the Department and Aquila met to discuss the finer points of the Company's proposal and to see if a potential agreement could be reached. The Department wanted to ensure that regulated assets were not being used to secure a larger credit facility than was needed to support domestic utility working capital needs. Thus, Aquila verbally agreed at the meeting that upon selling collateralized nonregulated assets, it would "pay down" the current $430 million TLF to $250 million. This would properly align the amount of credit required by Aquila's regulated domestic utilities and the size of the credit line that should properly be secured by regulated assets. This would preserve the separation principal discussed by the Department in its June 30, 2003 *Comments*.

However, after the meeting, Aquila changed its response to the Department's offer by concluding that if it would buy down the TLF other than as required by the terms of the TLF, there would be a significant pre-payment penalty, the "Make Whole Premium."[1]

A review of the appropriate section of the TLF convenants (Section 2.7(a)(1)) did not fully answer the Department's questions, so on August 4, 2003, the Department contacted Chris Reitz of Aquila for further clarification. This discussion revolved around the distinction of the definition of "pre-payment." It was learned that there are two different pre-payments, an "Optional" and "Mandatory" pre-payment. The Make Whole Premium is required only when Aquila makes an "Optional" pre-payment.

The definition of these two different pre-payments is based on the level of collateralization of the $430 TLF. The following two examples should explain the distinction between "Optional" and "Mandatory" pre-payments.

> <u>Optional Pre-payment</u>: The Company is required to maintain a collateral-to-debt ratio of 1.67 to 1; this is important to keep in mind. Thus, the <u>minimum</u> amount of collateral that is required for the $430 million TLF is $718 million. So, for example, if Aquila had $900 million in assets securing the TLF, the Company could sell $100 million of the $900 million in collateral and not be obliged to pay down the $430 million TLF. The ratio of collateral would be $800 million to $430 million, or 1.86 to 1, still in excess of the minimum ratio of 1.67 to 1. Therefore, Aquila could use the $100 million to repurchase more expensive outstanding debt or whatever uses it had for this money. However, if Aquila decided to use the proceeds to pay back part of the $430 million debt, it would have to pay a significant pre-payment (a.k.a. "Make Whole Premium) penalty.

> <u>Mandatory Pre-payment</u>: If, on the other hand, Aquila only had the minimum amount of collateral required for the TLF, $718 million, then any proceeds from the sale of assets would have to be used to pay down, without penalty, the $430 million TLF and maintain the 1.67 to 1 ratio. So, for example, if Aquila had $718 million in collateral for the TLF and then sold $100 million in assets, the collateral ratio would be $618 million to $430 million, or a ratio of 1.44 to 1. Thus, the bank would not allow Aquila to maintain the $430 million TLF because it would not be

[1] The "Make Whole Premium" basically refers to the loan conditions agreed to by the parties that govern the changes in the original payment schedule and terms

properly collateralized, according to the terms of the loan agreement. So for Aquila to maintain the 1.67 ratio with $618 million in collateral, the TLF would have to be paid down from $430 million to $370 million with no penalty involved.

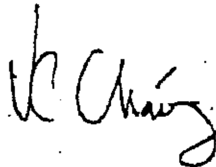
By over-collateralizing the TLF to such an extent, which would be the result if all five of the states (Colorado, Iowa, Minnesota, Missouri, and Kansas) approved the Company's request, the Company cannot pay down the TLF without penalty. If, on the other hand, the collateral and the TLF were properly aligned, based on the ratio of 1.67 to 1, portions of the asset sale proceeds would have to be used to pay down the TLF.

The bottom line is that the over-collateralization of the TLF does not allow the Company to refinance where it is most efficient. The $430 TLF has an interest rate of 8.75 percent (lowered to 8.00 percent when the 1.67 ratio of collateral to the amount of the TFL outstanding), which is expensive in today's environment. But if the loan is over-collateralized, Aquila cannot pay down the TLF without penalty. Thus, the Company would have an incentive to buy back other outstanding debt, but debt that is lower cost than the cost of the current $430 TLF.

Ideally, without the "Make Whole Premium" the Company would pay down the relatively expensive TLF, but because of the onerous loan covenants, the Company cannot do this. Thus, the Department concludes that it is counter to the needs of Minnesota ratepayers and even to the Company itself, to allow Aquila to encumber Minnesota regulated property. By properly aligning the collateral pool with the size of the TLF, the Company can more efficiently refinance its outstanding debt and thus benefit its ratepayers and shareholders.

The Department concludes that it would not be in the public interest if the Commission approved the Company's request. Therefore, the Department recommends that the Commission deny Aquila's request to encumber Minnesota regulated assets. The Department is available for any questions that the Commission may have on this matter.

Sincerely,



VINCENT C. CHAVEZ
Supervisor, Natural Gas Planning and Advocacy
(651) 296-0404

VCC/MDG/ja

STATE OF MINNESOTA)
) ss
COUNTY OF RAMSEY)

AFFIDAVIT OF SERVICE

I, **Linda Chavez**, on the **19th** day of **August, 2003**, served the attached **Minnesota Department of Commerce – Additional Comments**

Docket Number(s): **G007,011/S-03-681**

X by depositing in the United States Mail at the City of St. Paul, a true and correct copy thereof, properly enveloped with postage prepaid.

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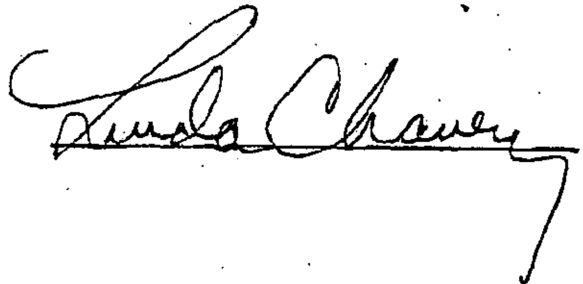
by express mai

by delivery service

to all persons at the addresses indicated below or on the attached list:



Schedule TJR-25.5

G007,011/S-03-681

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AQUILA, INC.
CASE NO. EF-2003-0465
SEDALIA INDUSTRIAL ENERGY USERS ASSOCIATION
AND AG PROCESSING INC.
DATA REQUEST NO. SIE-4

DATE OF REQUEST: June 5, 2003

DATE RECEIVED: June 5, 2003

DATE DUE: June 25, 2003

REQUESTOR: Stuart W. Conrad

QUESTION:

Please provide a 5-year projection of the cash sources and uses for each entity that would have access to the term loan facility. Provide a list of and explain all assumptions underlying each company's cash flow projections.

RESPONSE:

We have a 3-year forecasting period that provides cash flows for consolidated Aquila, Inc. and consolidated U.S. Utilities. All consolidated entities/businesses of Aquila, Inc. have access to the term loan facility. The Term Loan replaced our working capital revolver, and therefore is held by Aquila, Inc. Cash is managed on a centralized basis but used by each business entity. Aquila, Inc. is in effect functioning as a bank for all of the business operations. Internally we track the historical sources and uses and charge the appropriate entities for use of cash. We do not forecast cash flows at a lower level than the consolidated U.S. Utilities. Forecast assumptions have been provided in MPSC-0007.

ATTACHMENT:

File Name: Forecast with Financial Ratios

This file contains two tabs; 1) Consolidated Aquila, Inc. Financial Forecast and 2) Consolidated U.S. Utilities Financial Forecast

ANSWERED BY:

Steve Fisher

AQUILA, INC.
CASE NO. EF-2003-0465
SEDALIA INDUSTRIAL ENERGY USERS ASSOCIATION
AND AG PROCESSING INC.
DATA REQUEST NO. SIE-3

DATE OF REQUEST: June 5, 2003

DATE RECEIVED: June 5, 2003

DATE DUE: June 25, 2003

REQUESTOR: Stuart W. Conrad

QUESTION:

Please identify all entities that would have access to a collateralized loan agreement if Aquila's proposal in this proceeding is approved.

RESPONSE:

According to the terms of the agreement the funds would be available to all areas of Aquila's business but it is the Company's intention to ensure that the domestic regulated *businesses (7 state utilities) would have priority access to the capital provided by the loan* agreement..

ATTACHMENT: NA

ANSWERED BY: Randy Miller

FILE COPY

AQUILA, INC.
CASE NO. EF-2003-0465
DATA REQUEST NO. MPSC-66

DATE OF REQUEST: July 17, 2003

DATE RECEIVED: July 17, 2003

DATE DUE: July 31, 2003

REQUESTOR: Joan Wandel

QUESTION:

Please provide copies of the following Sedalia Industrial Energy Users Association's Data Request responses:

- Nos. 3 through 8;
- No. 9 Working Capital Analysis;
- Nos. 10 and 11;
- No. 12 Credit Reports; and
- No. 13 Security Analysts Reports on Aquila.

RESPONSE: Please see attachments.

ATTACHMENT: SIE DRs as requested.

ANSWERED BY: Mark Reed

SIGNATURE OF RESPONDER

AUG 8 2003

AQUILA, INC.
CASE NO. EF-2003-0465
SEDALIA INDUSTRIAL ENERGY USERS ASSOCIATION AND AG PROCESSING INC.
DATA REQUEST NO. SIE-12

DATE OF REQUEST: June 5, 2003

DATE RECEIVED: June 5, 2003

DATE DUE: June 25, 2003

REQUESTOR: Stuart W. Conrad

QUESTION:

Please provide a copy of all Aquila and Missouri utility operation's credit reports issued over the last 24 months.

RESPONSE: Please see attachments.

ATTACHMENT: Credit reports as requested

ANSWERED BY: John Hardt

Moody's Investors Service

Global Credit Research
Rating Action
9 APR 2003

Rating Action: Aquila, Inc.

MOODY'S ASSIGNS B2 TO SECURED BANK CREDIT FACILITY OF AQUILA, INC.

New York, April 09, 2003 -- Moody's Investor Service assigned a B2 rating to the proposed $430 million three year secured credit facility of Aquila, Inc. and confirmed the company's existing ratings. The rating on the three year seccured credit facility reflects the terms and conditions of the facility, including an assessment of the benefits and limitations of the collateral in the event of default. The facility benefits from collateral that includes assets of two regulated utility divisions. Coverage by directly pledged hard assets of the regulated utility divisions is relatively thin at closing, excluding properties on which the lenders will hold a second lien. The facility also is secured by the common stock of Aquila's substantial Canadian subsidiary, but Moody's does not attribute substantial value for notching purposes because of the residual nature of this claim. However, the facility also provides for the addition of further collateral upon regulatory approval for pledge of assets by five regulated divisions. Moody's considers it likely that regulatory approval will be received in at least some cases in the near term, resulting in an augmentation of the collateral coverage.

Ratings confirmed are:

Senior Implied B3

Senior Secured B2

Senior Unsecured Caa1

Subordinate Debt Rating Caa3

Preferred Stock Ca

Subordinate Shelf (P)Caa3

Junior Sub. Shelf (P)Caa3

The rating outlook is negative for the three year secured credit facility, consistent with the negative outlook for Aquila's other ratings.

Aquila's ratings reflect (1) weak cash flow generation relative to total debt despite recent asset divestitures; (2) asset sales proceeds which do not reduce debt incurred to purchase the same assets; (3) liquidity concerns related to unwinding its trading business, and (4) the quality of the collateral as mostly stock in subsidiaries.The ratings reflect Moody's concern that asset sales do not allow sufficient cash flow to repay parent debt to a level consistent with the expected cash generation of the remaining businesses. While cash flow from the remaining regulated utilities are expected to be less volatile, Aquila's efforts to unwind its trading business continue to pressure its operating performance and its asset sales have not resulted to debt reduction consistent with its ratings.

The negative outlook reflects the fact that the company continues to face liquidity pressure and substantial need to sell assets or obtain additional financing over the next year.

Aquila, Inc. headquartered in Kansas City, MO , is a regulated electric and gas networks business in the US, Canada, Australia and the UK.

New York
Daniel Gates
Managing Director
Corporate Finance Group
Moody's Investors Service
JOURNALISTS: 212-553-0376
SUBSCRIBERS: 212-553-1653

Schedule TJR-28.3

New York
Robert Johnson

FILED WITH
Executive Secretary
JUN - 2 2003
IOWA UTILITIES BOARD

PUBLIC

OFFICE OF CONSUMER ADVOCATE

PREPARED DIRECT TESTIMONY

and

EXHIBIT

OF

GREGORY VITALE

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

June 2, 2003

Schedule TJR-29.1

1 **Q: What is your name and business address?**

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

4 **Q: By whom are you employed?**

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

7 **Q: What is your educational background?**

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

11 **Q: What is your professional experience?**

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

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

1 Q: **Have you prepared an exhibit?**

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

5 Q: **What is the purpose of your testimony?**

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

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

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

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

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

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

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

3 [redacted]

4 [redacted]

5 [redacted], Iowa utility ratepayers may be

6 forced to remain with a financially weakened Aquila even if this were not in

7 their best interests.

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

9 A: Aquila was forced by its lenders to agree to the restrictive terms of this three-

10 year loan in order to avoid bankruptcy.

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

12 **years?**

13 A: Yes. It is Aquila's intent to continue pledging its utility assets as collateral

14 after this three year loan matures.

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

16 A: No. Aquila's proposal would, at best, leave a financially weak owner of its

17 Iowa utility operations for several more years. Aquila's proposal to pledge its

18 Iowa utility assets as collateral also fails to address, let alone solve, the

19 avoidable risks its utility operations have been and will continue to be

20 exposed to as long as Aquila commingles its regulated and unregulated

21 operations and finances.

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

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

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

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

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

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

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

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

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

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

4 Q: **How does Aquila finance its utility and its other unregulated operations?**
5 A: Aquila finances many of its operations on an overall basis and then internally
6 allocates funds to its various regulated and unregulated operations.

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

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

1 **Q: How have other utilities insulated their utility operations and customers**
2 **from their riskier unregulated operations?**
3 A: Most other companies protect their utility assets, finances and customers
4 through a holding company structure with a separate utility subsidiary. For
5 example, over 90% of the electric utility companies identified by the financial
6 publication Value Line have a holding company structure. The other utilities
7 that are not part of a holding company are smaller and have little, if any,
8 unregulated operations. Aquila is one of the few exceptions to this pattern.
9 Details are summarized on Schedule C.
10 **Q: How significant were Aquila's unregulated operations?**
11 A: Aquila earned more than 50% of its profits from its unregulated operations in
12 2001 when it had substantial energy trading and merchant operations.
13 **Q: Has the Board ever relied on a holding company structure to protect a**
14 **company's regulated utility from its other unregulated operations?**
15 A: Yes. The holding company structure, as the Board previously noted in a
16 MidAmerican proceeding, helps isolate regulated utility operations from
17 liabilities imposed by a company's other unregulated operations.[2]
18 **Q: Can the Board create its own firewall to protect Iowa utility customers**
19 **from Aquila's higher capital costs and lower bond rating?**

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

1 A: Yes, but only in part. The Board can protect Iowa utility customers from
2 Aquila's higher capital costs in a rate case. The Board cannot, however,
3 protect Iowa utility customers to the same extent in the event Aquila files
4 bankruptcy due to the losses from its unregulated operations. One of the
5 many risks is that Iowa utility customers could lose more than $500,000 in
6 deposits and funds if Aquila declares bankruptcy and their claims are treated
7 like other unsecured creditors.

8 **Q: In the event of a bankruptcy, has Aquila made its utility customers worse**
9 **off by agreeing to this loan?**

10 A: Yes. Prior to this new loan, the unsecured lenders' rights to any proceeds in a
11 bankruptcy proceeding would have been after the claims of Aquila's utility
12 customers. But now with this new loan as secured creditors, the lenders'
13 claims would be before Aquila's utility customers.

14 **Q: Because Iowa utility customers' funds are at risk, does it mean it would**
15 **be in their interest for Aquila to avoid bankruptcy?**

16 A: No. Aquila's utility customers are at risk whether Aquila files for bankruptcy
17 or manages to avoid bankruptcy as a financially weakened firm paying off
18 debts from its failed unregulated investments. Aquila's utility customers are
19 at risk as long as its regulated and unregulated finances are commingled as
20 they are now and would continue to be under this new loan.

1 **Q: How can Aquila's Iowa regulated utility customers be effectively**
2 **insulated from Aquila's unregulated operations?**
3 A: Iowa's utility operations can be protected as effectively as Portland General's
4 customers. Portland General continues to have an investment grade rating
5 even though Enron, its parent company, has been forced to file bankruptcy
6 due to its unregulated operations. Aquila's ongoing credit crisis is a result of
7 its investments in riskier unregulated but commingled operations. This makes
8 it obvious that the public interest, as well as safe and reliable utility service,
9 requires a standard corporate holding company structure with strict separation
10 of regulated utility assets and finances from unregulated operations.
11 **Q: How does Aquila justify pledging its regulated utility operations in Iowa**
12 **as collateral for this three year loan?**
13 A: Aquila claims that it needs this loan for working capital and that it is only fair
14 that all utility assets should be pledged as collateral in order to support the
15 working capital for its overall utility operations.
16 **Q: Does Aquila claim that its Iowa gas utility operations need additional**
17 **working capital?**
18 A: No. Aquila only claims that it needs to pledge additional working capital for
19 its overall utility operations.
20 **Q: How much is Aquila borrowing under this three-year loan for working**
21 **capital?**

1 A: The loan is for a total of $430 million. Aquila, however, claims that only
2 $250 million is needed for its overall utility working capital needs. The rest
3 would support Aquila's remaining unregulated assets and liabilities.

4 **Q: Should Iowa utility assets be pledged as collateral for Aquila's other**
5 **operations?**

6 A: No. Iowa utility assets should not be pledged as collateral to support this loan
7 which may be used by Aquila's riskier unregulated operations.

8 **Q: Doesn't Aquila claim that it would internally keep its regulated and**
9 **unregulated operations working capital needs separate?**

10 A: Yes. Aquila does assert it will separate access to the common pool of funds
11 made available by this loan between its regulated and unregulated operations.
12 Aquila's assertion, unfortunately, is unenforceable. It does not reflect the way
13 this loan is structured, the collateral rights of the lenders, the problems and
14 abuses that have arisen from a common pool of funds used to support both
15 regulated and unregulated operations, and the way Aquila has operated in the
16 past.

17 **Q: Do the financial institutions make the distinction between how the loan is**
18 **used or secured between regulated and unregulated operations?**

19 A: No. According to Mr Dobson, the financial institutions only require Aquila to
20 pledge sufficient assets to secure the $430 million loan.

1 **Q: How did Aquila determine that it needed this loan for its utility working**
2 **capital?**
3 A: Aquila claims it needs access to this loan for utility working capital based on
4 a new review of its peak needs and a review of other utilities working capital
5 arrangements.
6 **Q: Has the Iowa Utility Board ever relied upon Aquila's techniques to**
7 **determine working capital needs?**
8 A: No. Aquila's request to pledge its Iowa utility assets as encumbered collateral
9 for working capital is based on a unapproved methodology.
10 **Q: How have Aquila's working capital needs been determined for its Iowa**
11 **gas utility operations?**
12 A: In contrast to the unapproved method Aquila proposes, Iowa has long relied
13 upon a comprehensive analysis of the timing of each utility's incoming
14 revenues and outgoing payments to determine working capital needs.
15 **Q: When was Aquila's working capital needs for its Iowa gas utility**
16 **operations last reviewed?**
17 A: OCA witness Mr. Fasil Kebede filed testimony regarding Aquila's incoming
18 revenues and its various outgoing payments in RPU-02-5. This case was
19 ultimately settled in February, 2003.
20 **Q: What was the result of Mr. Kebede's comprehensive review of Aquila's**
21 **incoming revenues and outgoing payments?**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

1 Q: **Why does Aquila's request to pledge its Iowa utility assets as collateral**
2 **harm its customers?**
3 A: Aquila's proposal to pledge its Iowa utility operations as collateral harms its
4 Iowa utility customers because it unnecessarily encumbers its Iowa utility
5 operations for a loan that is not needed for its Iowa operations, [redacted]
6 [redacted]
7 [redacted]. Aquila's
8 proposal to pledge its Iowa utility assets as collateral also continues to leave
9 these operations at risk and does not address the underlying cause of this
10 financial crisis: Aquila's commingled regulated and unregulated finances.
11 Iowa utility customers would be better protected if Aquila would separate its
12 utility financing from its non-utility financing as many utility companies do.
13 Aquila's proposal does not accomplish this [redacted]
14 [redacted].
15 Q: **Can the harm that Aquila's corporate structure creates be quantified?**
16 A: Yes, but only in part. For example, Aquila has already spent $21 million to
17 restructure its operations since Enron's collapse into bankruptcy in December
18 2001, ostensibly to gain efficiencies and transparency that its failed
19 unregulated operations will not have an impact on its ability to provide
20 service to its ratepayers in the future. These costs could have been avoided
21 had Aquila first insulated its regulated utility operations from its unregulated
22 and riskier operations.

1 Q: **Are Aquila's utility customers harmed even if these costs do not directly**
2 **show up in their rates?**
3 A: Yes. Instead of incurring these costs, Aquila could, but won't be able to now,
4 pay down some of the legacy debt associated with its failed unregulated
5 investments. This would have led to Aquila regaining an investment grade
6 bond rating sooner. An investment grade bond rating best assures utility
7 operations access to capital in the future when it is needed at reasonable costs.
8 Q: **Should the Board allow Aquila to pledge its Iowa utility assets as**
9 **collateral for a working capital loan?**
10 A: No. The Board should reject Aquila's request to encumber its Iowa utility
11 assets for this loan which is not needed for working capital in Iowa,
12 unnecessarily encumbers and restricts future options that would be in its
13 ratepayers' interest and has made ratepayers worse off. At the least, Board
14 approval of Aquila's proposal should require Aquila to effectively insulate its
15 regulated utility and unregulated finances as most utilities already do under a
16 holding company with a separate utility subsidiary or agree to sell its Iowa
17 utility assets at the end of the three-year loan.
18 Q: **Will Aquila still have access to funds from this loan even if the Board**
19 **denies this proposal to pledge its Iowa utility assets as collateral?**
20 A: Yes. Aquila was only required to make a reasonable efforts to gain regulatory
21 authority to pledge additional utility properties as collateral to satisfy this loan

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

2 approval.

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

4 A: Yes. Based on my review, Aquila's request to pledge its Iowa utility assets as

5 collateral is for the benefit of its lenders and the current equity owners rather

6 than its Iowa utility customers. Aquila's proposal fails to address the

7 underlying factor responsible for this financial crisis: Aquila's continued

8 commingling of its regulated and unregulated financing. Aquila's proposal is

9 also based on an unapproved and erroneous procedure to determine its Iowa

10 utility working capital needs separate from a review of its other costs and

11 sources of revenues to cover those costs. Aquila's Iowa utility operations

12 already support a surplus of working capital. Aquila's proposal to pledge its

13 Iowa utility assets as collateral for this loan which is not needed for its Iowa

14 utility operations and that may be used to support Aquila's other operations,

15 including its unregulated operations, is not in its Iowa utility customers'

16 interest or the public interest. It is also not in the interest of Aquila's Iowa

17 utility customers or the public interest to have Iowa utility operations and vital

18 services dependent on a financially distressed firm that continues to fail to

19 correct the structural flaws that created this credit crisis that now puts its

20 utility operations at risk.

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

22 A: Yes, it does.

MINNESOTA
DEPARTMENT OF
COMMERCE

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June 30, 2003

PUBLIC DOCUMENT
TRADE SECRET DATA HAS BEEN EXCISED

Burl W. Haar
Executive Secretary
Minnesota Public Utilities Commission
350 Metro Square Building
121 7th Place East
St. Paul, Minnesota 55101-2147

RE: **Comments of the Minnesota Department of Commerce**
Docket No. G007,011/S-03-681

Dear Dr. Haar:

Attached are the comments of the Minnesota Department of Commerce (Department) in the following matter:

> A petition submitted by Aquila, Inc. pursuant to Minnesota Statute 216B.49, subdivision 3, requesting Minnesota Public Utilities Commission (Commission) approval to encumber Aquila Networks-Peoples and Aquila Networks-NMU Minnesota utility property to secure the payment of a $430 million loan (together with the First Mortgage Bonds, the Term Loan Facility) and to secure the future replacement debt offerings for working capital requirements not to exceed $430 million.

The petition was filed on April 30, 2003 by:

Jon R. Empson
Senior Vice President
Aquila, Inc.
1815 Capitol Avenue
Omaha, Nebraska 68102

The Department herein responds to the Aquila, Inc.'s (Aquila, or the Company) initial petition and subsequent written and oral responses to Department Information Requests. The Department recognizes that the Company filed "Supplemental Direct Testimony" on June 18, 2003, however, the Department has not had sufficient time to fully review this additional information prior to submitting its comments. The Department expects that Aquila can include this information in its Reply Comments and the Department can then address this discussion if so requested to by the Commission.

As to the current comments, the Department recommends that the Minnesota Public Utilities Commission **deny** Aquila, Inc.'s request to encumber Minnesota regulated property. The Department is available to answer any questions the Commission may have

Sincerely,

MARCUS D. GROSS
Rates Analyst

MDG/ja
Attachment

PUBLIC DOCUMENT - TRADE SECRET DATA HAS BEEN EXCISED

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

COMMENTS OF THE MINNESOTA DEPARTMENT OF COMMERCE

DOCKET NO. G007,011/S-03-681

I. SUMMARY OF AQUILA, INC.'S REQUEST

Pursuant to Minnesota Statute (Minn. Stat.) 216B.49, subdivision (subd. 3) and Minnesota Rules (Minn. R.), 7825.1200, 7825.1400, and 7825.1500, Aquila, Inc. (Aquila, or the Company) requests Minnesota Public Utilities Commission (Commission) approval to encumber Aquila Networks-Peoples and Aquila Networks-NMU Minnesota utility property to secure the payment of a $430 million loan (together with the First Mortgage Bonds, the Term Loan Facility) (Term Loan Facility) and to secure the future replacement debt offerings for working capital requirements not to exceed $430 million.[1]

On April 9, 2003, Aquila entered into the $430 million three-year Term Loan Facility and a 364 day $100 million loan that replaced an amount outstanding under the Company's prior revolving credit facilities and retired other maturing debt obligations.[2] In connection with the Term Loan Facility, Aquila has issued First Mortgage Bonds under its Indenture of Mortgage and Deed of Trust, dated as of April 1, 2003, to Bank One Trust Company, N.A., Trustee (the Indenture) and its First Supplemental Indenture thereto dated April 9, 2003, to Bank One Trust Company, N.A. Trustee (the First Supplemental Indenture). The Indenture, as amended and supplemented by the First Supplemental Indenture, constitutes a first mortgage lien on the property of Aquila. Currently, Aquila's regulated utility assets located in Michigan and Nebraska are subject to the lien of the Indenture.[3]

[1] Subd. 3. **Commission approval required.** 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.

[2] The $100 million loan can be increased to $200 million under certain circumstances, but would continue to be secured exclusively by non-domestic utility property.

[3] Michigan and Nebraska do not have state laws that require Commission approval for encumbrance of regulated assets.

According to Aquila, this Term Loan Facility is needed due to the Company's particular financial difficulties and the financial difficulties and requirements of the energy sector at large. Prior to the difficulties experienced by companies in the energy sector, Aquila was a diversified utility. The Company owned:

- Domestic and international utility networks;
- Merchant services (including wholesale energy and risk management services);
- Other energy industry investments (including electric generation, gas storage and gathering facilities); and
- Telecommunication operations.

The Company states that as a result of Enron Corporation's perfidy and the uncertainty resulting from the California energy crisis, creditors began to have concerns about the financial conditions of merchant energy companies. Thus, Moody's Investors Service (Moody's) and Standard and Poor's Corporation (S&P) developed more stringent credit guidelines for marketing and trading companies.[4] Specifically, Moody's and S&P were looking for merchant companies to have operating cash flow and/or access to additional liquidity substantially beyond traditional levels.

These guidelines raised the requirements for liquidity and balance sheet strength for merchant companies that Aquila could not meet nor sustain on an ongoing basis. Consequently, on August 2, 2002, the Company made the decision to voluntarily exit the merchant business. This decision left the Company with many stranded assets, which contain significant residual risk. Also, as Aquila attempted to shore up its balance sheet in the face of the energy-wide credit crunch, the Company was forced to sell many assets into a "buyer's" market, which resulted in sizeable book losses.

According to the Company, the deteriorating market conditions forced Aquila to violate certain interest coverage ratio covenants in the bank credit revolver. In the process of negotiating a new credit revolver and gaining a waiver of the covenant violation for the banks, Aquila had to agree to several conditions, including a commitment to make a reasonable effort to gain state regulatory approval to secure a new credit revolver with utility assets. This instant petition constitutes the Company's efforts to secure the Commission's approval to encumber Minnesota regulated assets.

II. DEPARTMENT'S ANALYSIS

The Department's analysis of this filing contains three Sections:

- financial review of Aquila;
- discussion of the Term Loan Facility and its purpose; and

[4] Aquila Merchant Services became one of the largest providers of wholesale energy and risk management services in North America. Aquila ceased merchant operations after August 2, 2002.

- effects of encumbrance.

Two main principles guide the Department's analysis:

1) A clear accounting separation must exist between any Minnesota utility's regulated and nonregulated activities. Regulated ratepayers are only responsible for paying the costs associated with providing regulated utility service to these customers. Requiring regulated ratepayers to assume responsibility for debts that were incurred to support nonregulated businesses violates the separation principle.

2) The encumbrance of Aquila's regulated assets in Minnesota must be in the interest of Aquila's Minnesota ratepayers.

Aquila has stated that encumbrance of regulated assets will produce two positive benefits for the Company. First, the Company will receive a 75 basis point reduction in the interest rate of the Term Loan Facility. Second, Aquila will use the funds above and beyond those required for domestic utility working capital needs to buy back more expensive outstanding debt. However, the Company failed to show how Minnesota ratepayers would profit from these two benefits specifically, and benefit from the encumbrance of Aquila's Minnesota assets in general.

Aquila's financial difficulties have been caused by its nonregulated operations. As DOC Attachment 1 shows, Aquila's regulated operations have been the only solid money making business for Aquila. "Telecommunications" and "Merchant Services," two lines of business in which Aquila became involved in since the late 1990's, have cost Aquila millions of dollars.

Any discussion of Aquila's request must begin with an analysis of Aquila's current financial position. The Department provides such an analysis below.

A. *REVIEW OF AQUILA'S FINANCIAL STANDING*

On January 15, 2003, the Aquila Financial Inquiry docket (Initial Comments) (Docket No. G007,011/CI-02-1369) was heard by the Commission. At that meeting, Mr. Randal Miller (Aquila Vice President Finance and Treasurer) explained the Company's plan for regaining its investment grade bond rating and its overall long-term financial viability. This section provides an overview of how the Company's financial situation has changed since that meeting.

1. Change in Financial Condition of Aquila

One measure of a company's financial soundness is rating agencies' bond "ratings" for that particular company. These ratings reflect the relative risk of investing in a certain company. In its Initial Comments in Aquila's financial review, the Department included Aquila's Senior Unsecured bond rating. At that time the Company's ratings were:

Moody's:	Ba2
Fitch Ratings (Fitch):	BBB-
S&P:	BBB-

Only Moody's rating was non-investment grade at that time. Both Fitch and S&P were one step above non-investment grade.

As of May 30, 2003, Aquila's current Senior Unsecured bond ratings are:

Moody's:	Caa1
Fitch:	B-
S&P:	B

All three of the bond ratings fell below investment grade. In fact, all three of the ratings are several steps below investment grade.

In assigning a rating to Aquila's new $430 million three-year secure credit facility Moody's stated recently:

> Aquila's ratings reflect (1) weak cash flow generation relative to total debt despite recent asset divestitures; (2) asset sales proceeds which do not reduce debt incurred to purchase the same assets; (3) liquidity concerns related to unwinding its trading business; and (4) the quality of the collateral as mostly stock in subsidiaries. The ratings reflect Moody's concern that asset sales do not allow sufficient cash flow to repay parent debt to a level consistent with the expected cash generation of the remaining businesses.

The non-investment grade of Aquila's debt and the discussion by Moody's indicate that Aquila may not be able to repay its debt obligations in a timely manner.

Another measure of financial soundness is the S&P Long Term Issuer Credit Rating Ratios. Standard and Poor's Compustat service provides these ratios. The Department included the fiscal year 2001 (FY01) information in its Initial Comments in Docket No. G007,011/CI-02-1369 as DOC Attachment 4. The same information for fiscal year 2002 (FY02) is included in these Comments as DOC Attachment 2. Of special interest are the "Pretax Interest Coverage" and "Cash Flow Interest Coverage" measures. As can be seen in DOC Attachment 2, both of these measures for FY02 are negative. These ratios indicate that Aquila does not have the income before taxes or the cash flow to cover its interest payments. Also, as can be seen in DOC Attachment 2, both of these measures for Aquila are comparable to measures for other utility companies that are in default.

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Also, as shown in DOC Attachment 3, the S&P sample Credit Scores show that Aquila's financial position has deteriorated when compared to the Company's financial position in FY01. As can be seen, all the Aquila "Implied Scores" are "BB" or are "Below B."[5] These ~~ratings~~ imply current financial adversity and a relative vulnerability to default.

2. *Asset Sales*

The most significant change since the Commission meeting of January 15, 2003, in which Aquila's financial standing was discussed before the Commission, has been Aquila's continued divestment of non-core assets. The following have been major divestments since January:

- On April 22, 2003, Aquila announced that it would sell all of its Australian interests for approximately US$589 million, which after fees, expenses, and taxes is projected to yield net cash proceeds of US$445 million at closing.[6]

- On May 13, 2003, Aquila announced that it had terminated its 20-year tolling commitment with Acadia Power Partners LLC for $105.5 million. Aquila paid Acadia $105.5 million to release Aquila from all of its obligations under the toll. The transaction returned to Aquila $45 million in posted collateral and eliminates $843 million in payments due to Acadia over the remainder of the 20-year term. Aquila entered into the contract with Acadia in 2000.[7],[8]

[5] According to Standard & Poor's Compustat Data Guide, "B indicates a greater vulnerability to default but currently have the capacity to meet interest payments and principal payments. Adverse business, financial, or economic conditions will likely impair capacity or willingness to pay interest principal. S&P also assigns the B rating to debt subordinated to senior debt that is assigned an actual or implied BB or BB- rating.

[6] These interests include:

- United Energy, managed and 34%-owned by Aquila, is an electric distribution utility in Melbourne, Victoria. United Energy also manages the gas distribution of Multinet Gas, in which Aquila has a 25.5% interest. United Energy and Multinet Gas distribute energy to 578,000 electric customers and 630,000 natural gas customers in areas of metropolitan Melbourne.

- Uecomm, 66%-owned by United Energy, owns fiber-optic communications networks. Uecomm serves corporate, government, and wholesale customers in five major Australian cities.

- Alinta Gas, 45%-owned by Aquila and United Energy jointly, is the major supplier and distributor of natural gas in the state of Western Australia. AlintaGas has 463,000 gas distribution customers in Western Australia, including the city of Perth.

[7] Under the toll, Aquila supplied the natural gas to a combined cycle power plant in Eunice, Louisiana, and paid fixed capacity payments for the right to sell into the wholesale market 580 megawatts of power generated by the plant.

[8] Aquila accessed the additional $100 million available under the 364-day bridge facility for the funds to buyout this contract with Acadia.

- On May 22, 2003, Aquila and FirstEnergy announced plans to sell their Aquila Sterling Ltd. Joint venture to Scottish and Southern Energy for $70 million. Aquila owns ~~79.9~~ percent of this joint venture and will share in the proceeds with FirstEnergy. Aquila's share is expected to net the Company about $14 million.[9]

These non-core asset sales will free up needed liquidity and resources for regulated assets, but the Company continues to have to take book losses on the sales, as assets are sold for less than the original purchase price. As Moody's states above these non-core asset sales are, "asset sales proceeds which do not reduce debt incurred to purchase the same assets."

3. *Summary*

The Department's analysis concludes that based on Aquila's current financial circumstances, as discussed above, the Company has not shown it is likely to generate sufficient cash flow to meet its future debt payment requirements.

B. *OVERVIEW OF TERM LOAN FACILITY*

1. *Loan Facility*

As discussed above, the combination of Aquila's August 2002 decision to exit the merchant business and the rapid divestiture of non-core assets that resulted in net book losses, caused the Company to breach several loan agreement covenants for maintaining specified interest coverage ratios. In order to avoid a mandatory repayment of the loans, Aquila received waivers of these breached covenants from a series of banks. The waivers and bank revolvers expired on April 12, 2003. Aquila's total debt due on April 12, 2003, was approximately **[TRADE SECRET DATA HAS BEEN EXCISED]**.[10]

In order to refinance these outstanding obligations, Aquila entered into a new $430 million, three-year secured credit facility, comprising a term loan facility and a pre-funded letter of credit facility.[11] Aquila also entered into a $200 million, 364-day bridge facility, comprising up to $100 million payable at closing and an option to draw an additional amount of up to $100 million.[12]

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[9] Aquila Sterling is the owner of Midlands Electricity, the fourth biggest electric utility in the United Kingdom. Midlands Electricity serves 2.4 million network customers and also owns interests in 884 megawatts of generating capacity in the United Kingdom, Turkey, and Pakistan.

[10] On that date, Aquila had **[TRADE SECRET DATA HAS BEEN EXCISED]**.

[11] The three-year Term Loan Facility is secured by a pledge of certain utility network assets in Nebraska and Michigan, the stock of the holding company for the Canadian utility operations, and a junior lien on certain of the Company's independent power projects (IPPs).

[12] The bridge facility was borrowed by UtiliCorp Australia, Inc., a wholly-owned subsidiary of Aquila, and is non-recourse to Aquila. The bridge facility will not be supported by an Aquila parent guarantee.

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This facility is intended effectively to serve as an advance on the planned sale of the Company's Australian investments and is secured by the pledge of the stock of certain of Aquila's Australian holding companies, certain Independent Power Projects (IPPs), as well as a junior lien of the Canadian operations.

On April 11, 2003, Aquila successfully issued the $430 Term Loan Facility collateralized by regulated assets in the states of Nebraska and Michigan and by the stock of its Canadian holding company. The above discussed loan agreements allowed Aquila to meet all of its April 12, 2003, obligations of **[TRADE SECRET DATA HAS BEEN EXCISED]**. The difference between Aquila's obligations and the total loan amount was only **[TRADE SECRET DATA HAS BEEN EXCISED]**, which is less than the stated amount needed for domestic utility working capital of $250 million. However, as the Company explained to the Department in a June 5, 2003, conference call, this **[TRADE SECRET DATA HAS BEEN EXCISED]** was combined with cash on hand to provide the Company with the needed domestic utility working capital.

2. *Operation and Use of Credit Facility*

There is a delay in the time between when Aquila purchases and pays suppliers for natural gas supplies and electric power purchases and when the cost for these purchases can be collected from Aquila's customers. Thus, Aquila must have access to working capital to maintain its operations. The Company has stated that it needs a credit facility of $250 million for domestic utility working capital needs across all of its jurisdictions.

The Company stated that it has conducted a study to ensure that $250 million is the proper amount of working capital that the domestic utilities require. Aquila has included this Working Capital Requirements Study (Study) as Exhibit 3 of Rick Dobson's Direct Testimony. The Study itself is trade secret, but its purpose is to show the amount of working capital Aquila will require for its domestic utility business. The Department reviewed the Study and found it to be reasonable. Further, the Department's review of the Study determined that the assumptions used are reasonable.

However, the Term Loan Facility would be used for more than just to support domestic working capital needs. The Company has stated that $250 million of the $430 million Term Loan Facility would be available for regulated use and $180 million of the $430 million Term Loan Facility would be available for nonregulated use. The Company has discussed selling its nonregulated assets, so it is not clear to the Department from Aquila's filing for what purpose the $180 million portion of the Term Loan Facility would be used. The Company has provided no information to show that any of the $180 million would go to support domestic regulated utility operations.

As stated in Section I. *Summary of Aquila, Inc.'s Request*, Aquila is using the regulated utility assets in Michigan and Nebraska, a pledge of the capital stock of the holding company of Aquila's Canadian utilities, and a junior lien on the equity interest in the holding company of Aquila's IPP investments as collateral for the $430 million Term Loan Facility. However, the Company wants to divest its non-core assets, thus it wants to release the pledge of the capital

stock of the holding company of Aquila's Canadian utilities and sell those properties. The Company expects to generate [TRADE SECRET DATA HAS BEEN EXCISED] from this sale, of which [TRADE SECRET HAS BEEN EXCISED] would be used to pay back debt of the Canadian holding company. Additional proceeds from this sale would be used to repay outstanding Aquila debt.

Under the terms of the Term Loan Facility, once Aquila sells the Canadian assets, the $430 million Term Loan Facility would be reduced because the Michigan and Nebraska regulated assets could only support a $200 million term loan facility. Thus, Aquila wants to substitute its other regulated utility assets in Missouri, Iowa, Minnesota, Kansas, and Colorado as collateral for the Term Loan Facility and maintain the $430 million loan capacity. Aquila's plan is that if it gains the various commission approvals to pledge these regulated assets, the assets would be encumbered and pledged directly to support the $430 million Term Loan Facility.

In a conference call with Company representatives on June 5, 2003, the Department sought to clarify how the extra $180 million portion of the Term Loan Facility would be used. The Company responded that after the sale of the Canadian assets, the Company would have some IPP's and some "remaining capacity service activity" on the nonregulated side. After further discussion with the Company, the Department concluded that the $180 million portion would not be used to support these nonregulated activities but, instead, would be used to buy back more expensive outstanding debt, albeit debt largely resulting from nonregulated activity.

Once the Canadian properties are sold, Aquila wants 100 percent of the $430 million Term Loan Facility to be supported by regulated assets. In its initial filing in this matter, Aquila made the argument that it is only "fair" to have regulated assets supporting a credit facility utilized strictly for its needs.

This argument is flawed. First, regulated assets, as shown by the Company in its Study, would require, in a worst case scenario, a $250 million credit facility. The Company's request in this docket is for a $430 million credit facility, $180 million more than required for regulated assets. Second, Aquila's need for credit facilities is the result of its failed nonregulated businesses. Such debt should not be backed up by regulated assets.

Aquila's proposal belies its claimed separation of regulated and nonregulated activities. While it claims to agree regulated assets should support a credit facility for use by regulated operations and nonregulated assets should support a credit facility for use by nonregulated operations, the Company's plan ensures that no nonregulated assets will be left among Aquila's business interests. Thus, no nonregulated assets would be available to support the extra $180 million portion of the Term Loan Facility. Aquila has made it known that if the various state commissions do not approve the encumbrance requests then the dollar amount of the Term Loan

Facility would have to be "waterfalled" down to an amount less than $430 million. To the Department, this is what should happen, as it is unreasonable for regulated assets to be used to support a credit facility for ~~use by~~ nonregulated operations.

Moreover, the Company is seeking to encumber regulated assets in order to use a credit facility, in part, to buy back debt that was, by and large, taken on by Aquila to pay for its various nonregulated activities. Such a request conflicts with the important principle of a strict accounting separation between the regulated and nonregulated operations of a utility. The idea of separation "to protect ratepayers from unwarranted costs" has been acknowledged by the Commission on numerous occasions, including the Order for Aquila's Financial Inquiry docket (Docket No G007,011/CI-02-1369).

Aquila has offered no compelling reason(s) that would justify violation of the principal of separation. Therefore, the Department recommends rejection of Aquila's request for approval to encumber Minnesota regulated assets.

C. EFFECTS OF ENCUMBRANCE

This Section discusses the implications of an encumbrance on Minnesota regulated property. The implications that will be discussed would potentially come about as a result of an Aquila bankruptcy filing. In no way is the Department expecting, forecasting, or otherwise predicting that Aquila may face bankruptcy. Any discussion of the impacts of a potential bankruptcy is included as a "worst case scenario" analysis.

1. Practical Implications of Encumbrance

As defined, an encumbrance is simply a lien or claim on property. The Department's concerns focus on the implications of a lien on Minnesota regulated property. As Aquila states on page 4 of its "Petition for Approval,"

> As explained below, pledging utility assets does not increase the risk to ratepayers, as a utility's assets are always available to debtors. The act of securing debt with utility assets is primarily a tool to improve the position of lenders over general creditors. Thus, it is important to the issuers of debt, but does not increase the risk for ratepayers.

Thus, according to the Company an encumbrance does not entail any risk in and of itself; the risk is with debt. In this case, the encumbrance is concerned with the Term Loan Facility, which is just one small part of the Company's overall debt. The Company claims that this encumbrance gives the Term Loan Facility creditors first claim to Aquila's assets, in the context of a bankruptcy proceeding.

An important issue, however, is whether or not the encumbrance somehow allows the creditor to seize and dispose of Aquila's regulated assets outside the protection of a bankruptcy proceeding. In Article IX in the *Indenture of Mortgage and Deed of Trust* agreement between Aquila and Bank One Trust Company, the Trustee (Bank One) may, in the event of default "enter upon and take possession of, the Mortgaged Property." Thus, if default occurs outside the protection of a bankruptcy proceeding then Aquila's Minnesota ratepayers will be disadvantaged vis-a-vis bankruptcy. The specifics are discussed further below.

2. *Default vs. Bankruptcy*

In response to Department Information Request No. 9 (DOC Attachment 4), the Company was asked if the Trustee could take possession of the encumbered assets without a bankruptcy proceeding. The Company responded:

> Yes, the contract gives the trustee that right. Unsecured creditors have a similar right to take possession of Aquila's assets and sell them for the purpose of satisfying judgements obtained against Aquila for defaulting on its obligations to them.
>
> The practical reality is that if a secured or unsecured creditor attempted to take possession of Aquila's assets for the purpose of satisfying Aquila's defaulted obligations to that creditor, Aquila would file for bankruptcy protection. The automatic stay provision of the bankruptcy code would require the creditor to immediately halt its collection efforts. Aquila would then be permitted to retain its assets and operate its business while it developed a reorganization plan in accordance with the bankruptcy code.

The Company attempts to minimize the possible effect of default. It claims that default on the Term Loan Facility and a bankruptcy filing are the same thing. It claims that, although the Trustee could take immediate possession of Aquila's property in an event of default this really would not occur because Aquila would seek bankruptcy protection to prevent that from happening. Then the bankruptcy court would sort out the specifics of the disposition of the Company's assets.

The document's own terms speak for themselves. The Company does not have to file for bankruptcy in the event of default. It is the Trustee's right to seize the Company's assets in the "Event of Default" and Aquila does not have to file for bankruptcy protection in that situation.

Aquila's response to Information Request No. 9 supports the Company's statement from Page 4 of the Petition that the risk is not with any regulated asset encumbrance but rather with the debt of Aquila. In sum, the risk for the ratepayers does not appear to be any greater with encumbrance than without encumbrance in the event of bankruptcy.

3. *Public Interest Standard*

The litmus test for the Department's recommendation for approval of the Company's request is that the approval would be in the public interest. Based on this standard, the Department must determine if the benefits of encumbrance (the purchase of more expensive outstanding Aquila debt with the $180 million of the Term Loan Facility and the 75 basis point reduction in the interest rate on the Term Loan Facility) significantly improves the Company's financial position. To date, the Company has not provided sufficient information that would allow the Department to reasonably conclude that encumbrance is in the public interest. Thus, the Department recommends the Commission reject the Company's request for approval to encumber Minnesota regulated assets.

Further, the Department has always maintained that a clear accounting separation must exist between a utility's regulated and nonregulated operations. Aquila's current request violates that premise. Aquila has offered no compelling reason(s) that would justify violation of this separation principle. Therefore, the Department recommends rejection of Aquila's request for approval to encumber Minnesota regulated assets.

In summary, the Department cannot identify how the Company's request to encumber Minnesota regulated assets is in the public interest. The Department invites Aquila to address the Department's concerns that have been detailed herein in the Company's Reply Comments.

III. CONCLUSIONS AND RECOMMENDATIONS

Based on its analysis, the Department concludes that Aquila's request for approval to encumber Minnesota regulated assets is not consistent with the public interest. Upon review of Aquila's request to encumber Minnesota regulated property, the Department recommends that the Commission deny the Company's request for approval, absent a showing in Aquila's Replay Comments of:

- A showing that encumbrance is in the public interest; and
- a compelling reason(s) to violate the principle of keeping a clear accounting separation between a utility's regulated and nonregulated activities.

/ja

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2002 & Q1 EBIT by Business Segment

($ Millions)	Full Year	Q1		
	2002	2003	2002	Variance
1) Global Networks Group:				
2) Domestic Networks	$ 125.8	$75.0	$ 45.0	$ 30.0
3) Quanta	(699.3)	(.2)	8.1	(8.3)
4) Communications	(256.1)	(4.2)	(7.0)	2.8
5) International Networks	(70.1)	10.6	33.6	(23.0)
6) Total Global Networks	(899.7)	81.2	79.7	1.5
7) Total Merchant Services	(671.0)	(101.3)	23.7	(125.0)
8) Corporate and Other	(37.7)	(1.1)	(16.7)	15.6
9) Total EBIT	$(1,608.4)	$(21.2)	$ 86.7	$ (107.9)
10) Interest Expense	249.5	65.1	48.6	(16.5)
11) Income Tax Benefit	(135.1)	(34.4)	(1.9)	32.5
12) Earnings (Loss) from Continuing Operations	$(1,722.8)	$(51.9)	$ 40.0	$ (91.9)

Schedule TIR-30.14

Docket No. G007,011/S-03-681

S&P LONG-TERM ISSUER CREDIT RATING RATIOS

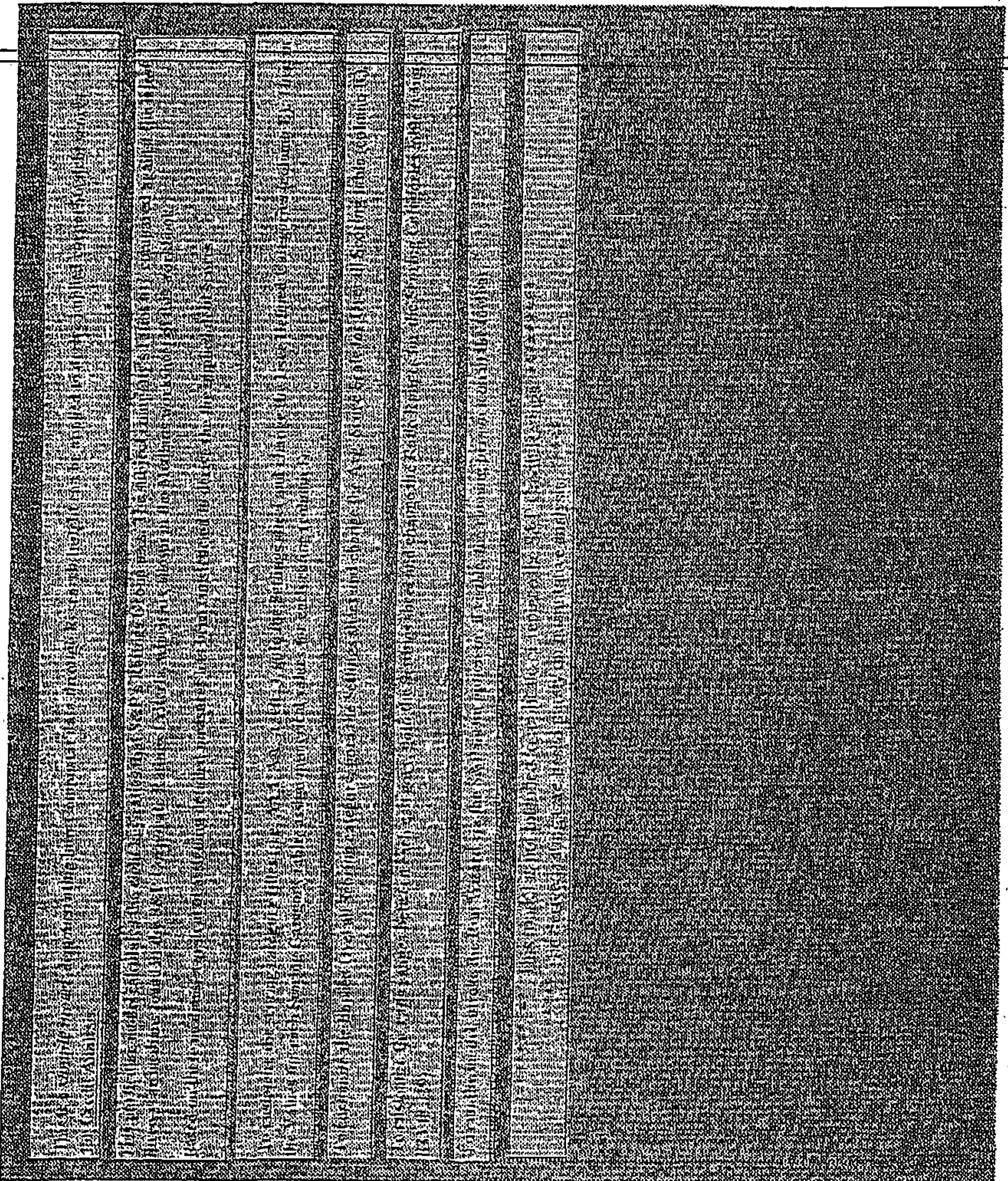
Industry Comparisons

GICS Group [Utilities]

Rating	# of Cos. 243	Long Term Debt % of Total Capital			Pretax Interest Coverage x			Cash Flow Interest Coverage x		
		Min	Avg	Max	Min	Avg	Max	Min	Avg	Max
AAA	1	[illegible]	[illegible]	56.9	[illegible]	1.2	1.2	1.9	1.9	1.9
AA	6	34.8	40.6	46.8	0.5	3.5	5.8	3.5	5.1	7.8
A	88	17.2	48.2	87.0	(1.0)	3.7	9.4	0.4	4.6	11.4
BBB	103	23.6	54.0	87.4	(1.3)	2.9	8.3	0.4	3.9	9.0
Speculative	40	25.4	59.4	127.4	(7.0)	1.5	8.6	(5.5)	2.1	7.1
In Default	5	(15,950.0)	(3,144.0)	113.4	(6.3)	0.7	4.0	(4.3)	1.3	4.0
AQUILA INC			59.7			(7.0)			(5.5)	

Rating	# of Cos. 243	Cash Flow % of Long Term Debt			Asset Turnover x			Equity Book Value/ Book Value of Liabilities		
		Min	Avg	Max	Min	Avg	Max	Min	Avg	Max
AAA	1	6.2	6.2	6.2	0.2	0.2	0.2	0.0	0.0	0.0
AA	6	17.0	32.9	67.0	0.4	0.5	0.7	0.3	0.5	0.7
A	88	(5.0)	27.3	80.0	0.2	0.4	0.9	0.1	0.5	1.9
BBB	103	(8.9)	22.3	67.5	0.1	0.4	1.1	0.1	0.4	0.9
Speculative	40	(62.9)	9.8	50.0	0.1	0.4	1.1	(0.1)	0.4	1.3
In Default	5	(220.4)	(17.3)	77.3	0.2	0.4	0.6	(0.1)	0.5	1.1
AQUILA INC			(62.9)			0.2			0.2	

Rating	# of Cos. 243	Return on Total Capital %			Operating Income % of Sales			Total Liabilities % of Tangible Net Worth		
		Min	Avg	Max	Min	Avg	Max	Min	Avg	Max
AAA	1	1.0	1.0	1.0	40.1	40.1	40.1	4,289.8	4,289.8	4,289.8
AA	6	(1.4)	4.9	11.3	19.2	21.8	25.2	134.9	375.4	1,321.8
A	88	(9.7)	5.5	13.6	9.2	28.3	76.5	(47,823.9)	(314.6)	1,604.8
BBB	103	(14.1)	4.4	15.1	(4.9)	25.7	62.6	(10,819.6)	(24.0)	2,553.5
Speculative	40	(47.8)	(1.5)	13.4	(72.2)	23.2	87.5	(6,258.6)	133.5	1,397.5
In Default	5	(15.1)	4.9	21.8	(131.7)	8.2	77.7	(1,724.6)	(389.8)	466.9
AQUILA INC			(42.9)			(72.2)			584.8	



Schedule TJR-30.16

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Ratios

For Years ended	Dec93	Dec94	Dec95	Dec96	Dec97	Dec98	Dec99	Dec00	Dec01	Dec02
EBIT Interest Coverage (x)	1.5	2.3	2.0	1.8	1.9	1.9	1.9	1.8	2.1	8.4
EBITDA Interest Coverage (x)	2.9	3.6	3.3	2.8	3.0	3.2	3.1	3.0	3.5	9.4
Funds From Operations as % of Total debt	22.9%	22.0%	16.7%	15.2%	21.1%	18.9%	12.7%	15.7%	14.3%	14.1%
Free Operating Cash Flow as % of Total Debt	13.8%	5.5%	8.6%	7.0%	12.5%	7.9%	12.2%	19.1%	14.9%	17.5%
Pretax Return on Permanent Capital	7.8%	10.3%	9.4%	10.4%	10.4%	11.0%	10.3%	11.2%	11.1%	30.0%
Operating Income as % of Sales	18.3%	24.4%	13.2%	8.1%	4.2%	3.1%	2.8%	1.9%	1.7%	-71.1%
LT Debt as % of Capitalization	51.2%	50.4%	60.0%	55.9%	54.4%	48.0%	61.4%	60.8%	52.4%	59.7%
Total Debt as % of Capitalization	52.9%	57.5%	64.4%	59.9%	58.5%	55.1%	64.0%	64.8%	54.4%	66.6%

Implied Scores

	Dec93	Dec94	Dec95	Dec96	Dec97	Dec98	Dec99	Dec00	Dec01	Dec02
EBIT Interest Coverage (x)	BB	BB	BB	BB	BB	BB	BB	BB	BB	Below B
EBITDA Interest Coverage (x)	BB	BBB	BB	BB	BB	BB	BB	BB	BB	Below B
Funds From Operations as % of Total debt	BBB	BBB	BB	BB	BBB	BB	BB	BB	BB	BB
Free Operating Cash Flow as % of Total Debt	A	BBB	BBB	BBB	BBB	BBB	BBB	A	BB	Below B
Pretax Return on Permanent Capital	BB	BB	BB	BB	BB	BBB	BB	BBB	BBB	Below B
Operating Income as % of Sales	A	AAA	BB	Below B	Below B	Below B	Below B	Below B	Below B	Below B
LT Debt as % of Capitalization	BBB	BBB	Below B	BBB	BBB	BBB	Below B	Below B	BBB	BB
Total Debt as % of Capitalization	BBB	BBB	BB	BBB	BBB	BBB	BB	BB	BBB	BB

Score Values

	Dec93	Dec94	Dec95	Dec96	Dec97	Dec98	Dec99	Dec00	Dec01	Dec02
EBIT Interest Coverage (x)	2	2	2	2	2	2	2	2	2	0
EBITDA Interest Coverage (x)	2	3	2	2	2	2	2	2	2	0
Funds From Operations as % of Total debt	3	3	2	2	3	2	2	2	2	2
Free Operating Cash Flow as % of Total Debt	4	3	3	3	3	3	3	4	2	0
Pretax Return on Permanent Capital	2	2	2	2	2	3	2	3	3	0
Operating Income as % of Sales	4	6	2	0	0	0	0	0	0	0
LT Debt as % of Capitalization	3	3	0	3	3	3	0	0	3	2
Total Debt as % of Capitalization	3	3	2	3	3	3	2	2	3	2
Average Score	2.875	3.125	1.875	2.125	2.25	2.25	1.625	1.875	2.125	0.75
Implied Overall Score	BBB	BBB	BB	BB	BB	BB	BB	BB	BB	B

Schedule TJR-30.17

AQUILA, INC.
DOCKET NO. G007,011/S-03-681
DATA REQUEST NO. DOC-9

DATE OF REQUEST: May 28, 2003

DATE RECEIVED: May 28, 2003

~~**DATE DUE:** June 9, 2003~~

REQUESTOR: Marcus Gross

QUESTION 9:

Subject: Event of Default; Remedies
Reference: "Indenture of Mortgage and Deed of Trust" Contract Article IX, page 71.

In the case of default, under the terms of Article IX *Events of Default; Remedies*, can the Trustee (Bank One Trust Company, N.A.) take possession of the encumbered assets without a bankruptcy proceeding? Please provide a detailed answer.

RESPONSE: Yes, the contract gives the trustee that right. Unsecured creditors have a similar right to take possession of Aquila's assets and sell them for the purpose of satisfying judgments obtained against Aquila for defaulting on its obligations to them.

The practical reality is that if a secured or unsecured creditor attempted to take possession of Aquila's assets for the purpose of satisfying Aquila's defaulted obligations to that creditor, Aquila would file for bankruptcy protection. The automatic stay provision of the bankruptcy code would require the creditor to immediately halt its collection efforts. Aquila would then be permitted to retain its assets and operate its business while it developed a reorganization plan in accordance with the bankruptcy code.

ATTACHMENT: NA

ANSWERED BY: Chris Reitz

AQUILA, INC.
CASE NO. EF-2003-0465
DATA REQUEST NO. OPC-5020

COPY

DATE OF REQUEST: September 2, 2003

DATE RECEIVED: September 3, 2003

DATE DUE:

REQUESTOR: Douglas E. Micheel

QUESTION:

Please list each and every financing application filed by Aquila within the past ten (10) years in which Aquila has requested financing approval from the Commission after Aquila has consummated the financing transaction.

RESPONSE:

Our traditional approach has been to file for financing approval before a loan agreement is closed. However in this case, we are in effect filing to substitute collateral in an existing loan agreement, not for approval to enter into a new loan. For example, we are seeking to replace the Canadian assets that currently serve as loan collateral, with domestic utility assets.

Without this approval, we will not have sufficient collateral to support the entire loan amount if Canada is sold. To keep the loan amount intact, we would be forced with either not selling Canada or our IPP portfolio, both of which are key elements to the successful implementation of our restructuring plan.

ATTACHMENT: N/A

ANSWERED BY: Jon Empson

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SIGNATURE OF RESPONDENT

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