STATE OF MINNESOTA
BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

LeRoy Koppendrayer	Chair
Marshall Johnson	Commissioner
Phyllis Reha	Commissioner
Gregory Scott	Commissioner

In the Matter of a Request by Aquila, Inc. for Authority to Use Aquila Networks-PNG and Aquila Networks-NMU Utility Property To Secure Indebtedness	MPUC Docket No.: G007,011/S-03-681

AQUILA, INC. REPLY COMMENTS

These Reply Comments are submitted by Aquila, Inc. and its Divisions Aquila Networks-PNG and Aquila Networks-NMU ("Aquila"), in response to the Minnesota Department of Commerce ("Department") June 30, 2003 Comments concerning Aquila's request to encumber its Minnesota utility property to secure the payment of $250 million of a $430 million loan and to secure future replacement debt offerings for working capital requirements. The Department recommends that the Minnesota Public Utilities Commission ("Commission") deny Aquila's request absent a showing in these Reply Comments that:

1. ratepayers will not assume responsibility for debts that were incurred to support nonregulated businesses; and

2. the encumbrance is in the public interest.

(Department Comments, p. 3.) The Department also stated that the "Supplemental Direct Testimony" filed by Aquila on June 18, 2003 was not considered in developing its recommendation and that Aquila could include this information in these Reply Comments (Department Transmittal Letter). These Reply Comments will address these issues and will demonstrate that Aquila's request, as conditioned below, should be approved.

I. Ratepayers Will Not Assume Responsibility For Debts Incurred To Support Nonregulated Businesses.

The Department is concerned that Aquila's proposal, once certain unregulated assets are sold, requires ratepayers to assume responsibility for debts incurred to support nonregulated businesses because the $430 million debt might not "waterfall' down as the unregulated properties are sold. While Aquila has always intended to segregate the use of the secured debt to support regulated and nonregulated operations, it is clear from the Department's Comments that a more concise statement of how that will occur, including a commitment to reduce debt as non-regulated assets are sold is needed. Therefore, Aquila makes the following commitment to address this concern:

> The amount of Term Loan Facility secured for utility operations will not exceed $250 million (unless a subsequent Aquila request is approved by the Commission authorizing an increase in utility working capital (e.g. because gas costs have increased). To the extent that the Term Loan Facility is used for both utility and non-utility operations, the amount of debt used for non-utility operations will be secured by sufficient non-utility assets (at a ratio of at least 1.67 to 1). The amount of the non-utility debt will be reduced as necessary to meet this commitment.

The Department reached its conclusion based upon an analysis of the collateral available to support the $430 million Term Loan Facility. The testimony from Aquila's Chief Financial Officer, Rick Dobson , states that Aquila has internally separated the $430 million into two components: $250 million to support the ongoing working capital requirements of the domestic utility business and $180 million to support the non-utility businesses. Aquila also testified that: "It is Aquila's intent to maintain a proper alignment of domestic utility collateral with domestic utility loan needs and nondomestic utility and nonregulated business collateral with their loan needs." (Dobson, page 11, lines 1-3.)

It appears that both Aquila and the Department agree on what the intent should be but the actual execution of that intent needs clarification. The needed clarification is a description of

what will happen when Aquila sells nonregulated and international utility collateral. In that case, the $430 million loan will be reduced, as necessary, to maintain the alignment stated in Mr. Dobson's testimony. That is, the $250 million needed by the domestic utility will be secured by utility collateral and the $180 million will be reduced to reflect the available nonregulated collateral. If no nonregulated business collateral is available, the portion of the Term Loan Facility not supporting the utility operations would be reduced to zero. If sufficient utility collateral is not available to secure the working capital needed by the utility, it would also have to be reduced to meet the collateralization ratio requirement.

As the Department recommends (page 9), the loan will be "waterfalled" down to an amount less than $430 million to reflect the available nonregulated collateral. Regulated assets will not be used to support a credit facility for use by nonregulated operations. 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. The Department's concern about violating the principal of separation will not happen.

These additional commitments, along with Aquila's earlier commitments to use a hypothetical cost of capital and investment grade debt costs in future rate cases demonstrate that ratepayers will not assume responsibility for, or the costs of, debt incurred to support nonregulated businesses.

II. The Encumbrance Is In The Public Interest.

The Department stated that the "litmus test" for its recommendation is whether approval is in the public interest. In making its initial determination, the Department identifies two benefits resulting from the Term Loan Facility:

1. As unregulated assets are sold, the $180 million portion of the Term Loan Facility previously used for the cash working capital needs of the nonregulated activities would be used to replace more expensive outstanding Aquila debt.

2. If the State Commissions allow utility property to be used to secure the debt, a 75 basis point reduction in the interest rate on the Term Loan Facility will occur (decreasing interest expense by $3.2 million a year).

The Department's Comments also addressed two potentially related matters: 1) the Department concludes that the Company may not be able to meet its principal and interest requirements; and 2) the Department noted that the lenders could acquire the utility assets without proceeding through bankruptcy. While the Department did not specifically list these issues as a reason for denying the application, the Company will respond to these observations made by the Department to ensure that the record is complete.

A. The Debt Issuance Is In The Public Interest Because It Provides The Working Capital Needed For Utility Operations.

The encumbrance of utility property to secure debt is routinely required by lenders as a condition of making capital available, and adds no additional risk. Therefore, the appropriate concern should not be whether the debt is secured, but rather, whether the debt is: a) needed for utility operations; and b) provided at a reasonable cost. The Department has not challenged either the need for, or the cost of, the debt.

The Department reviewed the Working Capital Requirements Study (Study) prepared by Aquila. The Study was developed to quantify Aquila's utility working capital needs. "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" (Comments, p. 7). Because both Aquila and the Department agree that working capital is needed, the issuance of debt in the requested amount for that purpose is in the public interest.

With respect to the cost of this debt, Rick Dobson's Direct Testimony, page 13, lines 15, through page 14, line 3, explains that the $430 million Term Loan Facility will be maintained at the corporate level and the funds will be used as if a revolver existed. That is, Aquila will

function as the bank for its utilities' cash working capital needs. A utility will only be charged for use of funds for the period of time when working capital is actually provided, and the cost of the funds actually used by the utility will be based upon the cost of debt to a BBB investment grade utility. The difference between the investment-grade cost and the actual cost of the debt will be retained at the corporate level – effectively sheltering utility customers from the cost of working capital if that cost exceeds investment grade levels. In this manner, Aquila is attempting to replicate how an investment-grade utility would meet the cash needs of its utility business. Consequently, the Term Loan Facility would not be included in the capital structure of either Aquila Networks-PNG or Aquila Networks-NMU. .

B. The Debt Issuance Is In The Public Interest Because It Will Help Aquila Return To Its Prior Status As An Investment Grade Utility.

The $430 million debt issuance is an integral part of Aquila's plan to return to an investment grade utility. Becoming an investment grade utility is in the public interest because utilities need access to large amounts of capital to assure safe, reliable and affordable service. While Aquila can meet those needs in the short-run without being an investment-grade utility, it would, over time, become increasingly more difficult and expensive.

The "Recommended Decision of Administrative Law Judge Dale E. Isley approving Stipulation and Settlement Agreement" for the State of Colorado, at paragraph 16, makes the following finding concerning the relationship of the debt issuance and the goal of becoming an investment grade utility:

> The parties believe that granting the application, subject to the terms of the Stipulation, is in the public interest. Having reviewed the Stipulation, the application, the prefiled testimony and exhibits submitted by Aquila in this matter, and the testimony presented by the parties at the hearing, the undersigned agrees. Subject to the conditions contained in the Stipulation, approval of the pledge of Aquila's Colorado utility assets to secure the loan will greatly assist Aquila's efforts to implement the Financial Plan and, ultimately, should serve to

return it to a capital structure reflective of a gas and electric utility and to restore its debt rating to investment grade.

The Colorado Administrative Law Judges' ("ALJ") recommended decision approving the encumbrance application became final on July 10, 2003 and a copy is attached to this filing. Jon Empson's Supplemental Direct Testimony (which was filed before the ALJ issued his recommendation) included a copy of the referenced Stipulation. As stated on page 4, line 3, of that Testimony, Aquila has accepted the conditions outlined in the Colorado Stipulation for application in Minnesota.

The Department made an observation that the Company might not be able to generate sufficient cash flow to meet its future debt payment requirements. The relationship of this observation and Aquila's request for approval of the debt issuance is unclear. The direct purpose of the secured debt at issue in this application is to provide the cash needed to meet peak cash working capital requirements. It is an important piece of the overall plan designed to return Aquila to an investment-grade utility. It helps Aquila meet its operational needs and consequently reduces, not increases, the risk of default or bankruptcy. The following discussion provides further information on actions Aquila is taking to meet its goal of returning to an investment grade utility.

First, the Company would like to correct an apparent typographical error on page 6 of the Department's Comments. Aquila's share of the sale of Sterling Ltd. Joint venture is expected to be closer to $46 million rather than "14 million" as stated in the first paragraph. However, correcting that typographical error does not remedy the Department's concern. In response to that concern, the Company offers four observations:

1. Denial of the Aquila's application could result in higher debt costs and less access to needed utility working capital, which would increase, not lessen the Department's concerns.

2. The analyses being completed by external parties and referenced by the Department are based upon publicly available information. Not included in those analyses, for example, is the fact that Aquila is in the process of filing a series of rate case requests in Missouri, Nebraska, and Colorado that will exceed $100 million annually. These requests are based upon the cost incurred to provide safe and reliable service to our utility customers in those states and do not reflect any cost derived from Aquila's nonregulated businesses or current financial position. While Aquila cannot predict the specific outcome of these rate cases, the Company stands behind the legitimacy of its filings.

3. When Aquila developed its Financial Plan, it attempted to be realistic, yet conservative, in its assumptions about the timing, extent, and the value of the asset sales. The experience so far has been that Aquila has moved faster and with better economic results than the Plan had originally anticipated.

4. The Financial Plan, by design, is not a static document and will be continually refreshed in order to ensure a successful transition back to an investment grade utility company. Assuming that the Department's observation is correct and Aquila will continue to have a significant amount of residual debt to support even after the nonregulated and international assets are sold, there are four sources of support for that debt. The debt secured by Minnesota utility property will not be used for that purpose. First, the Company will not restore a shareholder dividend payment until an appropriate capital structure has been developed. Therefore, the cash flow that would have gone to shareholders will be used to service the debt. Second, Aquila is preparing an application that will be filed with FERC to issue convertible debt. This debt will be used to retire existing debt, will have a lower cost and will be convertible to equity. The benefits are that Aquila's interest costs are lowered initially because the convertible rate is lower than the current embedded cost of debt and when the debt is converted to equity, the related interest cost

is eliminated. Third, the Company also intends to issue new equity, if market conditions are favorable. The proceeds from the new equity offering will be used to retire debt. Both the convertible debt and equity filings will be essentially "shelf registrations," to be executed when market conditions are right. Finally, if the Company is successful in gaining State Commission approvals of its encumbering applications, the interest rate on the $430 million debt will decrease by .75%, decreasing interest expense by $3.2 million a year.

Aquila has a sound plan to restore financial stability in a manner that protects Minnesota customers from adverse operational or financial impacts.

C. Using Utility Property To Secure Debt Does Not Increase Ratepayer Risk.

The Department states (page 10): "In sum, the risk for the ratepayers does not appear to be any greater with encumbrance than without encumbrance in bankruptcy." In fact, issuance of debt needed for operational needs at a reasonable cost decreases rather than increases the risk of bankruptcy or default. The Department also states that, in the event of a default outside the context of a bankruptcy, the lenders could take possession of the assets without a bankruptcy proceeding. While that is technically possible, in the event of a default, the Company would itself file for bankruptcy. In any event, pursuant to Minn. Stat. § 216B.50, the lenders acting directly could not obtain or in any dispose of the assets without prior Commission approval. Section 216B.50 states in part: "No public utility shall sell, acquire, lease, or rent any plant as an operating unit or system in this state . . . without first being authorized so to do by the Commission."

Securing debt affects the comparative rights of the debtors. It does not change any regulatory requirements, or affect the rights of ratepayers. The reason utilities grant security interests to lenders is because doing so increases the availability of capital and lowers the cost of the debt. Because granting a security interest increases the availability of capital and lowers the

cost of debt, it is common for utilities to have at least some secured debt. Rick Dobson's Direct Testimony, page 14, lines 12-26, and Exhibits 5 and 6, discusses the use of secured debt by utilities. The Supplemental Direct Testimony of Jon Empson documented that Minnesota Power, Excel Energy, Otter Tail Power, and Interstate Power and Light Company have all issued debt secured by their Minnesota utility property.

In its 10-K for fiscal year ended December 31, 2002, Allete, Inc. (parent of Minnesota Power) states: "Substantially all of our electric plant is subject to the lien of the mortgages securing various first mortgage bonds." See Attachment A to Jon Empson's Supplemental Direct Testimony. Minnesota Power's reliance on secured debt is further detailed in its Capital Structure Petition, Docket No. E015/S-02-161(approved by Commission Order dated April 10, 2002,), Exhibit H, which is included as Attachment B to Jon Empson's Supplemental Direct Testimony. Exhibit H lists $601,000,000 of First Mortgage Bonds that are secured with "MP Utility Property."

Xcel Energy's Capital Structure Filing, Docket No. E,G002/S-02-1907 (approved by Commission Order dated January 13, 2003), Attachment I, lists $818,915,000 of secured First Mortgage Bonds. Xcel also indicates that more than $155,215,000 of previously unsecured debt has been converted to secured debt since 1997. See Attachment C to Jon Empson's Supplemental Direct Testimony.

Otter Tail Power's Capital Structure Filing, Docket No. E017/S-02-49 (approved by Commission Order dated April 3, 2002), Attachment 6, lists $64,200,000 of First Mortgage Bonds. Otter Tail, in discussing potential First Mortgage Bonds that may be issued and sold in 2002 ("New Bonds"), states: "The New Bonds will be, generally speaking, secured by a first mortgage on all of the fixed properties of the Company, and will be on a parity with the other

First Mortgage Bonds of the Company, the terms of which are described generally on Attachment No. 6. ..." See Attachment D to Jon Empson's Supplemental Direct Testimony.

Interstate Power and Light Company's Capital Structure Filing, Docket No. G,E001/S-02-308, (approved by Commission Order dated April 24, 2002) lists First Mortgage Bonds outstanding of $139,000,000. See Attachment E to Jon Empson's Supplemental Direct Testimony.

While corporate organizational differences may exist between Aquila and utilities like Xcel Energy, which is able to issue stand alone debt, Aquila's commitment to use adequate non-regulated property to secure any debt used for non-utility operations provides adequate ratepayer protection.

III. Conclusion.

The request to encumber Minnesota regulated assets should be approved by the Commission:

- It is in the public interest.
- Ratepayers will not assume responsibility for debts incurred to support nonregulated businesses.

The amount of Term Loan Facility secured for utility operations will not exceed $250 million (unless a subsequent Aquila request is approved by the Commission authorizing an increase in utility working capital (e.g. because gas costs have increased). To the extent that the Term Loan Facility is used for both utility and non-utility operations, the amount of debt used for non-utility operations will be secured by sufficient non-utility assets (at a ratio of at least 1.67 to 1). The amount of the non-utility debt will be reduced as necessary to meet this commitment.

Aquila appreciates having the opportunity to provide additional information in response to the Department's Recommendations and intends to immediately pursue further discussions

with the Department to determine if the clarifications/commitments provided adequately address the Department's concerns.

Dated: July 15, 2003

Respectfully submitted,

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