

Exhibit No.:	
Issue:	Encumbrance of Missouri Assets
Witness:	Jon R. Empson
Sponsoring Party:	Aquila, Inc.
Type of Exhibit:	Surrebuttal Testimony
Case No.:	EF-2003-0465
Date Testimony Prepared:	September 26, 2003

**MISSOURI PUBLIC SERVICE COMMISSION**

**SURREBUTTAL TESTIMONY**

**OF**

**JON R. EMPSON**

**ON BEHALF OF**

**AQUILA, INC.**

September 26, 2003

VERIFICATION

STATE OF NEBRASKA    )  
                                  )  
COUNTY OF DOUGLAS    )        ss.

Jon R. Empson, having been duly sworn upon my oath, state that I am the Senior Vice President – Regulatory, Legislative and Gas Supply Services of Aquila, Inc., that I am authorized to make this affidavit on behalf of Aquila, Inc., and that the matters and things stated in the foregoing sur-rebuttal Testimony and schedules thereto are true and correct to the best of my information, knowledge and belief

Jon Empson

Signed and sworn to before me, the undersigned notary public, on this 25<sup>th</sup> day of September, 2003.



Teresa A. Keefe  
Notary Public

My Commission Expires:  
October 31, 2005

1                                   **BEFORE THE PUBLIC SERVICE COMMISSION**  
2                                   **OF THE STATE OF MISSOURI**  
3                                   **SURREBUTTAL TESTIMONY OF JON R. EMPSON**  
4                                   **ON BEHALF OF AQUILA, INC.**  
5

6       Q.   What is your name and title?

7       A.   Jon R. Empson, Senior Vice President, Regulatory, Legislative and Gas Supply  
8           Services for Aquila, Inc. (“Aquila” or “Company”).

9       Q.   Are you the same Jon R. Empson that filed direct testimony in this case before  
10       the Missouri Public Service Commission (“Commission”)?

11      A.   Yes.

12      Q.   What is the purpose of your surrebuttal testimony?

13      A.   The purpose is:

- 14           1. Introduce the other surrebuttal witnesses filing testimony on behalf of  
15           Aquila and the issues they will address.
- 16           2. Respond to several of the positions taken by Commission Staff (“Staff”)  
17           and the Office of Public Counsel (“OPC”) in the rebuttal testimony filed  
18           by those parties in this case.

19      Q.   Who are Aquila’s other surrebuttal witnesses in this case?

20      A.   Rick Dobson, Chief Financial Officer for Aquila will address the specific  
21           allegations made by certain intervenor witnesses about the impact that using  
22           Missouri assets to secure a working capital loan has on Aquila’s Missouri  
23           customers.

24           Carol Lowndes, Senior Financial Manager for Aquila Networks will provide  
25           surrebuttal testimony on the working capital calculation for Missouri and internal  
26           money transfer program used at Aquila.

1 Glenn Keefe, Operating Vice President for Missouri Electric, will respond to the  
2 testimony relating to the operational performance of the Missouri electric  
3 properties.

4 Brett Carter, Vice President for Central Services, will respond to the testimony  
5 about the performance of Aquila's call center.

6 Q. What has been your role in obtaining approval of the debt securitization  
7 applications made in Missouri and also in Kansas, Colorado, Minnesota and  
8 Iowa?

9 A. It has been my responsibility for overseeing the entire process from application  
10 and testimony preparation to data request response and involvement in  
11 settlement discussions. I have maintained this direct involvement in order to  
12 make sure Aquila's position and commitment to the basic principles outlined in  
13 the direct testimony of Mr. Dobson and myself were consistently communicated  
14 and maintained. When a company has five applications in different jurisdictions  
15 being processed at the same time, maintaining this focus and consistency have  
16 been very important.

17 **Rebuttal Testimony of Joan C. Wandel**

18 Q. Do you agree with Staff witness Joan C. Wandel when she states at page 8,  
19 lines 26-27 of her testimony that, "Aquila agreed to provide their lenders utility  
20 collateral for amounts that the Company would use for non-regulated  
21 operations"?

22 A. No, I do not. I do agree that Aquila has made application to add utility property  
23 to the collateral pool to support the \$430 million loan, but I cannot agree that the  
24 utility collateral will be used for non-regulated purposes

25 Q. Please explain.

1 A. Aquila has made the collateral alignment commitments made by Company  
2 witness Rick Dobson at page 10, lines 18 – 25 of his direct testimony. There is  
3 found the following question and answer:

4 Q. Did the financial institutions actually split the loan and collateral  
5 pools as you described?

6 A. No. The financial institutions only required Aquila to have pledged  
7 sufficient assets in total to secure the \$430 million loan. Aquila  
8 itself is separating the loan and collateral to ensure that the utility  
9 customer and assets are not supporting the non-utility debt  
10 requirements. It is Aquila's intent to maintain a proper alignment of  
11 domestic utility collateral with domestic utility loan needs and non-  
12 domestic utility and non-regulated business collateral with their loan  
13 needs. (emphasis added)

14 Q. Do you agree that Aquila is “repaying and refinancing debt that it incurred  
15 unrelated to utility working capital need with the Term Loan proceeds” as  
16 witness Wandel alleges at page 9, lines 19 – 20 of her testimony?

17 A. No. As witness Wandel states on page 10, lines 12 – 14, the Term Loan is  
18 replacing “a previously existing \$650 million unsecured revolving loan...” witness  
19 Wandel's rebuttal testimony continues with this exchange at pages 10 and 11:

20 Q. What was the purpose of this \$650 million revolving loan?

21 A. According to the information provided by the Company during the  
22 July 2003 interview, the monies were used to provide working  
23 capital to the various regulated and non-regulated operations of the  
24 Company as well as provide funds for the short-term construction  
25 needs of those same operations. (page 10, lines 20 – 22; page 11,  
26 lines 1 – 2)

1 Q. Do you agree with witness Wandel at page 11, lines 3-4, where she says that  
2 the new loan is not structured like the \$650 million loan?

3 A. The new loan is structured as a three-year term loan. However, as part of  
4 Aquila's commitment to its utility customers, we are internally treating the Term  
5 Loan as a revolver, the same as the \$650 million loan referenced by witness  
6 Wandel. This concept is explained in Mr. Dobson's direct testimony, page 13,  
7 lines 16 – 24 which follows:

8 Q. How will Aquila internally manage the 3-year term loan funds to  
9 support the utility working capital requirements?

10 A. Aquila will hold the term loan at the corporate level and use the  
11 funds as if a revolver existed. That is, Aquila, Inc. will function as  
12 the bank for the business operations. The utility operations will only  
13 be charged for the use of funds when working capital is needed and  
14 the cost of the funds used will be based upon a BBB investment  
15 grade utility. The difference between the investment grade cost  
16 and the actual cost of the debt will be retained at the corporate  
17 level. Aquila is effectively sheltering the utility customer from the  
18 cost of working capital if it exceeds investment grade levels.

19 Q. Who bears the extra interest cost of the Term Loan?

20 A. The shareholders of Aquila, not its customers, are bearing the extra interest  
21 cost of the Term Loan.

22 Q. How do you react to Staff witness Wandel's discussion on page 48 of her  
23 testimony, lines 1 – 19, relating to the cost of credit lines already included in the  
24 cost of service?

25 A. Without reviewing the detailed work papers, I will assume that her testimony is  
26 correct about Staff including the cost of traditional line of credit in our last

1 electric rate case. It is also a fact that this cost determination will not change  
2 going forward.

3 Q. Why?

4 A. Aquila has taken this Term Loan and converted it internally into a traditional  
5 revolver. The Missouri customers will only pay for the funds when used and  
6 then at a short-term rate comparable to an investment grade utility. The  
7 Company's shareholders, not its Missouri customers, are bearing this cost  
8 difference between the Term Loan and the revolver.

9 Q. Is the pledging of regulated utility collateral with a debt capacity of at least \$430  
10 million detrimental to the public interest as stated by witness Wandel at page 47  
11 of her testimony, lines 3 – 9?

12 A. No. The regulated utility property will not be the only assets used to secure the  
13 \$430 million Term Loan. As the company has continually stressed, the  
14 collateral pool will consist of both regulated and non-regulated assets. The  
15 collateral value of each asset group will support the working capital needs of  
16 that asset group. There is no subsidy since Aquila has internally made this  
17 alignment. Furthermore, a public detriment can occur as a result of this  
18 transaction only if the customer rates or services are adversely impacted. As  
19 described earlier, the Term Loan will be functioning as a traditional revolver and  
20 the Staff has agreed that costs associated with a traditional revolver can be  
21 recovered in rates. Moreover, in any event, rates cannot change without  
22 Commission approval. In addition, there are no allegations in the testimony of  
23 the other parties that customer service will be impacted by the transaction.

24 Q. Do you agree that the Term Loan did not provide any additional funds for  
25 working capital as stated by witness Wandel, page 47, lines 13 – 14?

1 A. No. Mr. Dobson will address this in more detail, but essentially this Term Loan  
2 replaced a \$650 million working capital loan that expired on April 12, 2003.  
3 Aquila had drawn the cash from this loan prior to April 12, 2003 and had the  
4 cash on its balance sheet. The Term Loan did pay off the Company's existing  
5 working capital loan, but the cash remained on our balance sheet to be used to  
6 support working capital needs.

7 **Rebuttal Testimony of Ted Robertson**

8 Q. Do you agree with OPC witness Ted Robertson that it is likely that Missouri  
9 assets will be utilized as collateral for debt associated with Company's non-  
10 regulated activities?

11 A. No. As explained in my response to the same claim made by Staff witness  
12 Wandel, Aquila has committed to maintain a collateral alignment so that utility  
13 assets are supporting utility needs and non-utility assets are supporting non-  
14 utility needs.

15 Q. Is it Aquila's plan "that the regulated assets of all its domestic utilities be  
16 encumbered and pledged to directly support the entire \$430 million Term Loan  
17 Facility" as alleged at page 13, lines 9 – 11 of Mr. Robertson's testimony?

18 A. I checked Mr. Robertson's Schedule 8 that he states supports this statement  
19 and could not find his quoted reference. Schedule 8 discusses the effects of  
20 bankruptcy.

21 Q. What is Aquila's plan then?

22 A. Again, the plan is clearly laid out in Mr. Dobson's testimony and my response  
23 earlier in this testimony to a similar statement made by Staff witness Wandel.

24 Q. Do you agree with Mr. Robertson's conclusion at page 19 of his testimony, lines  
25 14-17, that "Aquila's response to the Minnesota Public Utilities Commission was



1 not entirely accurate with regards to the amount of regulated utility collateral it  
2 had to support its estimated regulated utility working capital needs”?

3 A. No. Aquila’s witness Rick Dobson stated in his direct testimony filed with the  
4 Commission in this case on April 30, 2003 the following (page 10, lines 11 –  
5 16):

6 “However, based upon the collateral principles used by the lending  
7 institutions, the assets in the two domestic utility states are not sufficient  
8 in value to support a \$250 million loan. Therefore, Aquila had to use the  
9 Canadian investment both to support the remaining \$180 million portion  
10 of the loan and to fill the gap on the required collateral for the \$250  
11 million utility requirement. I have provided the details of the collateral  
12 support in Schedule RD-2.”

13 It appears that Mr. Robertson conducted his own set of calculations. The  
14 exhibit clearly shows that at the time Schedule RD-2 was created by CSFB the  
15 debt capacity for Michigan and Nebraska was only [\*\*\*], not the [\*\*\*] that Mr.  
16 Robertson calculated.

17 Q. Did other rebuttal witnesses in this case make the same mistake?

18 A. No. Staff witness Wandel, on page 46, lines 1 – 9, of her testimony, shows that  
19 she understands how the assets were originally valued for purposes of debt  
20 capacity.

21 “The valuation of the Company’s assets is provided on Schedule RD-2 of  
22 the direct testimony of Company witness Dobson. The values of these  
23 assets, for purposes of determining their collateral value (debt capacity  
24 value), is accomplished by taking the value of the assets, reducing that  
25 value for any outstanding debt and then multiplying that amount by the  
26 loan value factor. Those loan factor values were set at 50% for the initial

1 collateral, which included the Canadian properties, Michigan regulated  
2 utility properties and Nebraska regulated utility properties.”

3 Q. Do you agree that Aquila was not “concerned with fairness when it encumbered  
4 the assets of the Michigan and Nebraska utilities” as claimed by Mr. Robertson  
5 at page 21, lines 6 – 14?

6 A. No. Aquila was very sensitive to the issue and met with the appropriate  
7 personnel in both Nebraska and Michigan before these assets were pledged. In  
8 Nebraska, we notified the Chairs of the Rate Area Committees (Nebraska did  
9 not have a PSC) and had a personal meeting with the City Attorney in Lincoln,  
10 Nebraska, our largest city. These representatives understood the legal  
11 environment in Nebraska and expressed appreciation for the courtesy we  
12 demonstrated by giving them advanced information. The concept of pledging  
13 Michigan assets was discussed during the settlement of Aquila’s 2002 rate  
14 case. Aquila Chairman and CEO Rick Green and I also met personally with  
15 Michigan Staff and Commissioners on March 18<sup>th</sup>, before the new loan  
16 agreement was executed and on April 30<sup>th</sup>, after the loan agreement was signed  
17 to keep them informed. In fact, we are scheduled to meet again with the  
18 Commissioners and Staff on October 6, 2003.

19 While legally we did not need formal approval in Michigan and Nebraska, we  
20 made a concerted effort to keep them informed.

21 Q. Do you agree with Mr. Robertson’s characterization of Aquila’s financial plan at  
22 page 33 of his testimony, lines 28-29, “as withdrawing from the money losing  
23 non-regulated activities”?

24 A. No. As stated by Mr. Dobson in his direct testimony, page 3, lines 22 – 24:

1           “The Merchant Services Group provided \$384 million in operating  
2           expenses before interest and taxes in 2001, about 56% of Aquila’s total  
3           operating income.”

4           I cannot agree that the non-regulated activities were money losers.

5           Then on page 5, lines 20 – 26, Mr. Dobson explains the real reason for the  
6           development of the financial plan:

7           “The credit agencies raised the requirements for liquidity and balance  
8           sheet strength for merchant companies to a level that Aquila could not  
9           meet nor sustain on an ongoing basis. On August 6, 2002, Aquila  
10          announced its difficult decision to voluntarily exit the merchant business,  
11          the first Top 10 energy merchant company to make this decision.”

12          He then explains in detail the consequences of executing this decision (pages 7  
13          – 8).

14          Q. Have you experienced similar misunderstandings about the reason that Aquila  
15          has developed a financial plan?

16          A. Yes. There is no doubt that Aquila’s employees have expressed and continue  
17          to express frustration and even anger about how the demise of the merchant  
18          business within Aquila has impacted them personally. This past year has been  
19          a very difficult time and employees, just like the parties in this case, were first  
20          focused on assigning blame. In hindsight, we can all have 20/20 vision but I  
21          have tried to explain our situation in different terms and get our employees to  
22          put the past behind them and focus on the future.

23          Q. How have you discussed this issue with employees?

24          A. I have tried to have employee meetings on a regular basis to answer questions  
25          and provide a forum to vent frustrations. In my initial meetings, I attempted to  
26          translate Mr. Dobson’s direct testimony in this case into an analogy. I asked

1 employees to assume that they were buying a house and the bank set a credit  
2 limit of 25% of their gross monthly income as a maximum monthly mortgage  
3 payment. You execute the mortgage with that understanding. Over time your  
4 income increases as your career progresses and the equity in your home  
5 increases. You make a decision that you could buy a new car by taking out a  
6 home equity loan and still meet the credit limit of 25% of your gross monthly  
7 income. Later, you use your home equity to buy other tangible items for your  
8 family. After several years, your bank decides that based upon experiences  
9 with other mortgages that the 25% credit limit is no longer workable and that  
10 starting immediately, your monthly mortgage payment can only equal 15% of  
11 your gross monthly income. What do you do? You have to start selling the  
12 tangible items, potentially at a loss, to reduce your monthly mortgage payment  
13 to comply with the 15% credit rule. That is essentially what has happened to  
14 Aquila. The Enron debacle basically changed the credit rules for all companies  
15 operating in the merchant business. While we can all engage in hindsight  
16 discussions about the decisions made to be in the merchant business, the fact  
17 is that the rules changed and Aquila is doing its best to transition out of the  
18 merchant business back to a U.S. utility and is committed to protecting its utility  
19 customers in the process.

20 Q. What is your reaction to Mr. Robertson's testimony on page 38, lines 21 – 27  
21 where he says:

22 "Company would have the Missouri Public Service Commission, and the  
23 regulatory Commission's in the other states believe that on the one hand  
24 it intends to never collateralize the non-regulated proceeds of the Term  
25 Loan with regulated assets then, on the other hand if they do, tough,  
26 because that is the reality of how a utility that is not owned by a holding

1 company must operate. Public Counsel believes that the facts speak for  
2 themselves; the potential for regulated assets to be utilized as collateral  
3 to support the non-regulated proceeds of the Term Loan is real, and  
4 likely, if Aquila's application is approved"?

5 A. Mr. Robertson is simply incorrect. Since Mr. Robertson was not personally  
6 involved in the discussions with DOC that preceded Aquila's Reply Comments,  
7 he might lack the proper perspective to interpret the Reply Comments. I would  
8 encourage the Commission to read, in its entirety, the ten page Reply  
9 Comments Aquila sent to the Minnesota Commission on August 29, 2003,  
10 Schedule TJR-15.1 – 15.11. On page 9 of those comments, Aquila summarized  
11 its position which is and has always been consistent:

12 "In summary, the Company is moving with all reasonable speed to sell all  
13 of its unregulated assets. When the assets are sold, the Term Loan will  
14 be reduced to the \$250 million needed for utility operations.

15 In its July 15, 2003 Reply Comments, Aquila made the following  
16 commitments:

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

1 The commitment couldn't be clearer. The issue of disagreement in Minnesota  
2 was how the proceeds from the sale of non-regulated assets would be used. It  
3 was Aquila's position that as long as the Company had sufficient non-regulated  
4 collateral to support the \$180 million non-regulated loan allocation, the non-  
5 regulated proceeds should be used to retire the highest cost or most cost  
6 effective liability. Simply put, why retire 8.75% (or 8.0%) Term Loan debt if you  
7 can retire 14.875% debt as long as you have maintained the collateral  
8 alignment? The Minnesota Department of Commerce ("DOC") preference was  
9 to retire the \$180 million portion of the Term Loan as soon as possible even if  
10 sufficient non-regulated collateral still existed. DOC had also assumed that the  
11 Term Loan interest rate was the Company's highest. Aquila has consistently  
12 maintained the "collateral alignment principle" in every jurisdiction and Mr.  
13 Robertson's characterization of the Minnesota comments is simply wrong.

14 **Rebuttal Testimony of Mark Burdette**

15 Q. Do you agree with OPC witness Mark Burdette that "some of Aquila's customers  
16 already suffered detriment due to the company's increased risk due to  
17 unregulated, operations" as he claims at page 12, lines 6-17 of his testimony?

18 A. No. First, there has been no increase in rates charged to the former St. Joseph  
19 Light & Power Company ("SJLP") customers since the merger. Second,  
20 consistent with Aquila's capital assignment policy, the SJLP customers  
21 maintained the SJLP debt in the capital structure for future ratemaking. Third,  
22 the Commission has already rejected the OPC's projection of future detriment  
23 argument in the Report and Order, dated December 14, 2000, In the Matter of  
24 the UtiliCorp United and St. Joseph Light & Power Company merger.

25 "Public Counsel argues that the downgraded credit rating will increase  
26 the cost of debt for SJLP's ratepayers above the cost of debt for SJLP

1 absent the merger. Public Counsel argues that this will lead to higher  
2 rates for SJLP's ratepayers and constitutes a detriment that should lead  
3 to the rejection of the merger. Public Counsel's argument is not  
4 persuasive."

5 Since Aquila has committed to price all future assignments to all its divisions,  
6 including SJLP, at the same BBB investment grade that existed at the time of  
7 the merger, there is no detriment. The Commission also stated in the Report  
8 and Order that "certainly there is no guarantee that SJLP's credit rating would  
9 remain at A- if the merger does not proceed."

10 Q. Mr. Burdette states at page 19, lines 14-16 of his testimony, that Aquila has  
11 admitted that it plans to eventually have the Term Loan collateralized solely with  
12 regulated assets. Do you agree?

13 A. Absolutely not. Mr. Burdette has taken the same deceptive path that I have  
14 already discussed relative to Mr. Robertson's testimony.

15 Q. What is the "mistaken belief" reference by Mr. Burdette?

16 A. The DOC had made two assumptions:

17 1. The Term Loan interest rate was the high cost debt, which was not  
18 correct. As described in the Minnesota Rely Comments. (Robertson  
19 Schedule TJP-15.4) Aquila has higher cost debt that should be retired  
20 first as long as the collateral alignment is maintained.

21 2. Paying down the Term Loan with sale proceeds was the best alternative,  
22 which was not correct. Aquila's Minnesota Reply Comments, (Robertson  
23 Schedule TJR-15.4 – 15.7) provide a detailed explanation of why this is  
24 not the best alternative use of funds.

25 Again, I would encourage the Commission to read Aquila's Reply Comments in  
26 their entirety (Robertson Schedule TJR – 15.1 – 15.11). Contrary to Mr.

1 Burdette's representations, Aquila has maintained consistency in all of its  
2 jurisdictions. Consequently, Mr. Burdette's allegations are unjustified.

3 Q. Do you agree with Mr. Burdette's statement that "Assuming the Company  
4 divests all of its unregulated assets, eventually the Term Loan Facility will be  
5 collateralized ONLY with regulated assets"?

6 A. His statement is true only if the Term Loan Facility has been reduced to the  
7 level of working capital for utility needs. As stated earlier, Aquila will maintain a  
8 proper collateral alignment and at such time that all of the non-regulated assets  
9 have been sold, the Term Loan will be reduced to the level necessary to support  
10 the working capital requirements of the utility.

11 **Rebuttal Testimony of Ronald R. Bible**

12 Q. Has the Company stated that the use of an allocated capital structure and  
13 allocated debt costs ensures that adequate funds will be available in Aquila's  
14 treasury for Aquila Networks – MPS and Aquila Networks – L & P when they  
15 need working capital as claimed by Staff witness Bible (page 3, lines 18 – 27;  
16 page 4, lines 1 – 9)?

17 A. No. Aquila has stated that the approval of this application is what will enable  
18 Aquila to maintain adequate working capital.

19 Q. What was the Company's reference to what Mr. Bible characterizes as  
20 "allocated" capital structure and "allocated" debt costs?

21 A. On page 2 of my direct testimony, I begin my discussion of the "three key  
22 business principles" that are guiding Aquila's actions during this transition  
23 period. The number 1 principle was "protect utility customers from potential  
24 adverse financial impacts" which included the maintenance of a hypothetical  
25 capital structure and long-term debt assignments as well as pricing any new or  
26 replacement utility debt at a BBB investment grade rating. Therefore, when



1 rates are set for our Missouri customers, they would be insulated from the  
2 financial challenges Aquila is facing and there would be no detriment as a  
3 result. Mr. Bible has chosen to use the descriptor “allocated” when referring to  
4 the capital assignment process used by Aquila.

5 Q. Mr. Bible uses the word “claims” several times in his testimony when he  
6 describes the Aquila capital allocation process (page 4, lines 17 – 19; page 5,  
7 line 9). Did Mr. Bible receive a copy of Aquila’s “Business Unit Capitalization  
8 Procedures” that in fact describes this process?

9 A. Yes he did. During the three-day transcribed interviews in this case conducted  
10 by the intervening parties, Aquila provided a copy of the procedures.

11 Q. Did this document describe the objectives for establishing the capital structures  
12 for each of the business units?

13 A. Yes. The report listed six objectives of which the following two are most  
14 relevant.

- 15 1. To appropriately finance each business unit with the proper mix of  
16 capital reflecting economic activity, risk profiles and market based  
17 comparative capital structures; (emphasis added)
- 18 2. To insulate each business unit from the activities of other business units  
19 and from UtiliCorp operations. (emphasis added)

20 The report goes on to say that the “establishment of unique business unit  
21 capital structures and the long-term maintenance of those structures  
22 implemented in 1988 met each of these objectives

23 Q. Has the 1988 study been updated?

24 A. The basic concepts for having a hypothetical capital structure do not require an  
25 update. The comparable companies and appropriate capital structure is  
26 reviewed and updated every time an Aquila division files a rate case.

1 Q. Was each business unit assigned a hypothetical capital structure based upon  
2 “market based comparative capital structures?”

3 A. Yes. The target or hypothetical capital structure for each business unit was  
4 consistent with the capital ratios displayed by publicly traded companies with  
5 similar risks within the industry, which that business unit operates.

6 Q. Have you had any recent rate case experience where this Aquila method of  
7 developing hypothetical capital structures was reviewed?

8 A. Yes. In Minnesota Docket No. G007,011/GR-00-951 the Minnesota Department  
9 of Commerce witness Eilon Amit filed the following direct testimony on  
10 December 13, 2000 (page 26, lines 3 – 21; page 27, lines 1 – 24)

11 Q. Please discuss PNG’s and NMU’s capital structures.

12 A. PNG and NMU are both division companies of UtiliCorp Company.  
13 Both do not issue their own long-term debt or shares of common  
14 equity. Instead, UtiliCorp provides all the capital needs of PNG and  
15 NMU.

16 Q. What methods does UtiliCorp use to allocate capital to its divisions  
17 and subsidiaries?

18 A. UtiliCorp sets capital structure targets for each of its main divisions  
19 and subsidiaries. These targets are based on the investment risks  
20 of each division or subsidiary and are set to be comparable to the  
21 capital structures of similar publicly traded companies.

22 Q. Do you agree with the methodology used by UtiliCorp to determine  
23 the capital structure for each of its division and subsidiary?

24 A. Yes. UtiliCorp’s methodology of determining the capital structures  
25 for each division and subsidiary is consistent with established  
26 financial principles.

1 Q. What are the capital structures proposed by the Company to be  
2 used in this rate case?

3 A. The Company proposes to use NMU and PNG December 31, 1999  
4 book capital structures.

5 Q. Please state these capital structures.

6 A. These capital structures are:

PNG Division Capital Structure		
December 31, 1999		
	Amount	
	000	Percentage
Short-Term Debt	\$123	.03%
Long-Term Debt	241,286	49.98
Common Equity	241,287	49.99
Total	\$482,696	100.00%

NMU Division Capital Structure		
December 31, 1999		
	Amount	
	000	Percentage
Short-Term Debt	\$12	0.3%
Long-Term Debt	22,945	49.98
Common Equity	22,944	49.99
Total	\$45,901	100.00%

7 Q. Are these capital structures reasonable?

1 A. Yes. PNG's and NMU's capital structures are reasonable because  
2 they are based on appropriate financial principles and their long-term  
3 debt and equity ratios are similar to the long-term debt and equity  
4 ratios of my comparison group, respectively.

5 Q. Is the capital structure assignment process you have described consistent with  
6 Mr. Bible's definition of a hypothetical capital structure?

7 A. It appears so. Mr. Bible describes a hypothetical capital structure as a "capital  
8 structure different than the entity's actual capital structure, and is usually  
9 derived from an analysis using a group of comparable companies." (page 5,  
10 lines 1- 3)

11 Q. Doesn't Mr. Bible differentiate between a hypothetical capital structure and what  
12 he terms an "allocated" capital structure (page 5, lines 1 – 7)?

13 A. Yes, he does. However, Mr. Bible is attempting to make a distinction without a  
14 difference. His own definitions acknowledge that an allocated capital structure  
15 may be based on a hypothetical capital structure. His definitions have no  
16 meaning for how Aquila uses the terms of assigned or hypothetical capital  
17 structure. I have defined the capital allocation process in my testimony and in  
18 my reference to our "Business Unit Capitalization Procedures."

19 Q. How has the Commission characterized Aquila's "capital allocation process?"

20 A. In Case No. ER-93-37, the Commission stated the following at page 16 of its  
21 February 25, 1994 Report and Order:

22 "Since MPS is not publicly traded and does not issue capital, it does not  
23 have an independent capital structure and is therefore theoretically  
24 hypothetical. Thus, both OPC's and MPS's proposed capital structures  
25 are hypothetical." (emphasis added)

1 Q. Why did Mr. Bible go to such extreme to characterize Aquila’s capital structure  
2 process as “allocated” rather than “hypothetical”?

3 A. I am not sure. However, on page 6, lines 5 – 7 of his testimony, Mr. Bible  
4 appears to be attempting to reclassify Aquila’s capital structure process in order  
5 to discount my reference to the Staff Report I made in my direct testimony.

6 Q. Did Mr. Bible provide his “workpapers” for how he derived these distinctions?

7 A. Yes he did. He provided two books as authority for his conclusions. While I  
8 only had time to briefly review the materials in Jefferson City, I could not find the  
9 source for his distinction between hypothetical capital structure vs. allocated  
10 capital structure.

11 Q. Do you think this distinction is relevant to your testimony?

12 A. No, I do not. Mr. Bible treats the terms “hypothetical” and “allocated” as terms  
13 of accounting science that have defined meanings. I use these references as  
14 terms of “art” to demonstrate intent consistent with the descriptions used in my  
15 testimony and Aquila’s “Business Unit Capitalization Procedures”.

16 Q. In reviewing Mr. Bible’s workpapers, did you find a reference to hypothetical  
17 capital structure?

18 A. Yes. There were several. In the book The Cost of Capital – A Practitioner’s  
19 Guide, by David C. Parcell, there is a description of the circumstances where a  
20 hypothetical capital structure is used for a utility. The most common reasons for  
21 utilizing a hypothetical capital structure are:

22 1. The utility’s capital structure is deemed to be substantially different from  
23 the typical or “proper” utility capital structure.

24 2. The utility is funded as part of a diversified organization whose overall  
25 capital structure reflects its diversified nature rather than its utility  
26 operations only.

1           These reasons are consistent with Aquila’s rationale for creating a hypothetical  
2           capital structure process in 1988.

3           Q. Do you agree with Mr. Bible at page 6, lines 7-8 of his testimony that the  
4           effectiveness of hypothetical capital structures in preventing or mitigating  
5           increased capital costs being passed onto MPS and SJLP ratepayers can occur  
6           within the context of a rate case?

7           A. Yes. As Mr. Bible knows, Aquila has been proposing the use of a hypothetical  
8           capital structure in virtually every rate case in every jurisdiction since 1988. It  
9           was Aquila’s opinion that Aquila’s consolidated capital structure did not reflect  
10          the proper capital structure for a utility. I also recognize that the Commission  
11          has not always accepted the concept of using a hypothetical capital structure in  
12          past ratemaking procedures. However, the past is really not relevant for what  
13          Aquila is proposing in this docket. We are simply stating that Aquila will be  
14          internally continuing to maintain a hypothetical capital structure based upon a  
15          comparable company analysis so the Missouri customers will not pay for any  
16          increased capital costs or have a related financial detriment associated with our  
17          restructuring efforts. The Staff has validated that the use of a hypothetical  
18          capital structure during a rate case proceeding can indeed provide the financial  
19          protections Aquila is seeking.

20          The Commission can determine itself within the context of a rate case if Aquila’s  
21          proposed hypothetical capital structure and debt assignment process has  
22          adequately protected the customer.

23          Q. But hasn’t Mr. Bible stated that a lower credit rating of the regulated utility will  
24          result in a higher debt cost for the utility? (page 11, lines 9 –17)

25          A. Yes. Mr. Bible is theoretically correct, but Aquila has already addressed the  
26          concern by committing to first maintain the debt initially assigned to the utility

1 properties when we were investment grade and second that any new or  
2 replacement debt will be assigned at a BBB investment grade, the credit rating  
3 Aquila had for at least the last 10 years prior to the changes we are now  
4 experiencing. There will be no financial detriment to Aquila's utility customers  
5 as a result of the credit downgrade. Aquila's shareholders, by not receiving a  
6 dividend, are bearing that cost. The utility customers of Aquila will not  
7 experience any detrimental impact in their rates as a result of Aquila cost of  
8 capital increasing. Any change in Aquila's rates can only occur with  
9 Commission approval.

10 Q. But isn't Mr. Bible more concerned about sheltering or separating utility from  
11 non-utility operations or protecting utility customers from the other activities of  
12 Aquila outside the context of a rate case?

13 A. That appears to be what he is stating on page 6 of his testimony, lines 8 – 10. I  
14 would agree with Mr. Bible that the use of a hypothetical capital structure within  
15 the context of a rate case can effectively shelter ratepayers, but is not a  
16 "structural" tool to shelter outside a rate case. However, Mr. Bible has not  
17 provided any evidence that the utility customers of Aquila are or will experience  
18 any financial detriment outside the context of a rate case. Again, Aquila's rates  
19 can't change without Commission approval.

20 Q. Is it possible for any organization to effectively ring-fence or insulate one  
21 business operation from another?

22 A. First, while Mr. Bible attempts to differentiate between "ring fencing" and  
23 "insulating", I do not believe there is a difference in meaning. In fact, the article  
24 in Mr. Bible's workpapers entitled "Ring-Fencing" A Subsidiary from Standard &  
25 Poors CreditWeek; October 27, 1999 appears to use the terms synonymously:

1 “The problem with these devices is that by themselves they do not go far  
2 enough in effectively insulating or ring-fencing the subsidiary from its  
3 parent.” (emphasis added)

4 Second, a paper presented at the July NARUC summer meeting, entitled “Ring  
5 Fencing Mechanisms for Insulating a Utility in a Holding Company System”  
6 (Surrebuttal Schedule JRE – 1) made several insightful statements:

- 7 ▪ There is no perfect ring fence that can completely insulate a utility.
- 8 ▪ More importantly, companies have an inalienable right to file a  
9 subsidiary into bankruptcy.
- 10 ▪ A company cannot waive this right

11 Aquila agrees that its current corporate structure makes structural ring fencing,  
12 as it relates to bankruptcy, virtually impossible at this time due to loan  
13 agreement covenants and the current debt structure. However, the paper  
14 presented at NARUC made another interesting point:

15 “Financial restrictions imposed solely through internal corporate policies  
16 are a weaker method of isolating issuer risks relative to those mandated  
17 by law, regulation, or contract because the corporation may adjust its  
18 policies at will. Nevertheless, corporate policies are helpful indicators of  
19 management intent.” (emphasis added)

20 Q. What are Aquila’s corporate policies relative to this application?

21 A. Aquila has essentially declared its utility properties investment grade. In other  
22 words, while Aquila might be non-investment grade, Aquila is treating all of its  
23 utility properties as investment grade. Aquila is behaving as if an outside credit  
24 rating agency has determined that a ring fence exists and the credit risk of  
25 Aquila’s utility properties had been insulated from the credit risk of the  
26 Company.



1 Q. Can you explain that further?

2 A. Yes. Aquila has gone to great lengths to ensure that the rates to its utility  
3 customers should not be impacted by the credit issues facing the Company.

4 1. A hypothetical capital structure is being maintained and can be accepted  
5 or modified by the Commission during a rate case proceeding for  
6 ratemaking purposes. The intent of the hypothetical capital structure is  
7 to insulate utility customers from the risks within the corporation by  
8 setting rates based upon the mix of debt and equity that is appropriate to  
9 Aquila's Missouri utilities.

10 2. The hypothetical capital structure will contain investment grade debt  
11 either issued at the time it was needed by the specific utility or if new or  
12 replacement debt, priced at the investment grade of BBB.

13 3. Any lead-lag calculation in rate cases will be developed in a manner that  
14 normalizes or neutralizes any potential impact of prepayment for energy  
15 supplies. (OPC DR 629, 630, 632, 633 attached as Surrebuttal Schedule  
16 JRE – 2).

17 4. A collateral alignment will be maintained to ensure that utility assets are  
18 supporting the defined utility working capital needs and non-utility assets  
19 are supporting the non-utility needs.

20 5. The Term Loan will function as an internal revolver with the utility  
21 properties only paying for the use when needed and then at an  
22 investment grade, short-term interest rate.

23 Q. Staff witness Wandel and OPC witness Robertson provide comments about the  
24 status of the approval process of Aquila's debt securitization application in  
25 Colorado, Iowa, Kansas and Minnesota. Do you have any reactions to their  
26 comments?

1 A. Staff witness Wandel provided a good, factual summary of the status of our  
2 cases on pages 49 – 50 of her testimony. However, OPC witness Robertson  
3 attempts to disparage the Colorado decision by characterizing the Staff review  
4 as “limited” and implying that Colorado decision somehow didn’t comprehend  
5 the complexity of the application. I disagree. Having personally participated in  
6 the pre-filing meetings and settlement discussions with the Colorado Staff, it is  
7 obvious that they had a comprehensive understanding of our request. In fact,  
8 much of the content of our initial direct testimony filed in all jurisdictions was  
9 based upon information that the Colorado Staff asked us to include so that they  
10 could process the application in a timely manner.

11 Q. Could you provide more detail about the process of approval in Colorado?

12 A. Yes. Aquila initially filed an application to pledge Colorado assets in late 2002.  
13 At that time, we did not include any testimony but only submitted a legally  
14 required application. The Colorado Staff and Office of Consumer Counsel both  
15 intervened and the Staff issued the seven data requests referred to in Mr.  
16 Robertson’s testimony (page 15, line 7). Aquila recognized that Staff needed  
17 information to process the application that we could not provide at that time  
18 since the actual financing had not been completed. Therefore, after conferring  
19 with the Staff and the Consumer Counsel, we agreed to withdraw our  
20 application and refile when we had more information. Aquila had a meeting with  
21 the Staff and Consumer Counsel to discuss in detail what additional information  
22 they needed and we provided that information in the form of testimony with the  
23 application we re-filed on May 1, 2003.

24 Q. What happened next?

25 A. After we re-filed, Staff intervened in the case. After Staff had time to review the  
26 filed application, we requested a meeting to discuss potential settlement. Beth

1 Armstrong, U.S. Networks CFO, Steve Denman, Aquila Colorado Counsel, Gary  
2 Stone, Aquila Operating V.P. for Colorado Electric and I met with Staff on May  
3 29, 2003. At that meeting, Staff acknowledged that Aquila had addressed most  
4 of their concerns in our filed direct testimony, but that they still had questions.  
5 The settlement agreement states the following:

6 “On May 15, 2003, Staff filed its notice of intervention, and entry of  
7 appearance. Aquila and Staff are the only parties to this docket. Since  
8 the date of the filed application, Staff has conducted a thorough review  
9 and investigation of the filing and the supporting testimony and  
10 exhibits. Aquila and Staff have also conducted extensive discussions  
11 and settlement negotiations.” (Robertson Schedule TJR – 12.4)

12 We reached agreement and filed a settlement on June 6, 2003. On June 17,  
13 2003, a hearing was held on the formal Stipulation and Settlement Agreement  
14 (attached to Mr. Robertson’s testimony as Schedule TJR-12.1 – 12.30).  
15 Administrative Law Judge Dale E. Isley made the following comments in his  
16 decision dated June 20, 2003:

17 16. The parties believe that granting the application, subject to the  
18 terms of the Stipulation, is in the public interest. Having reviewed the  
19 Stipulation, the application, the pre-filed testimony and exhibits  
20 submitted by Aquila in this matter, and the testimony presented by the  
21 parties at the hearing, the undersigned agrees. Subject to the  
22 conditions contained in the Stipulation, approval of the pledge of  
23 Aquila’s Colorado utility assets to secure the Loan will greatly assist  
24 Aquila’s efforts to implement the Financial Plan and, ultimately, should  
25 serve to return it to a capital structure reflective of a gas and electric  
26 utility and to restore its debt rating to investment grade. Aquila’s

1                    agreement to use the hypothetical capital structure called for by the  
2                    Stipulation and to separate regulated utility debt/assets from non-  
3                    regulated debt/assets for the purpose of allocating finance costs  
4                    ensure that the requested pledge of Colorado utility assets will not  
5                    negatively impact the rates paid by Colorado ratepayers. These  
6                    measures will also ensure that the requested pledge of assets will not  
7                    result in the use of Colorado ratepayer funds to subsidize Aquila's non-  
8                    regulated activities in violation of § 40-3-114, C.R.S. Finally, Aquila's  
9                    compliance with the reporting requirements imposed by the Stipulation  
10                    will serve to ensure that the pledge of assets will not negatively impact  
11                    the adequacy and reliability of Aquila's Colorado regulated services. It  
12                    is found and concluded, therefore, that the Stipulation is in the public  
13                    interest and should be accepted and approved. (emphasis added)  
14                    (Schedule TJR-12.7).

15                    I cannot agree with OPC witness Robertson that the Colorado review was  
16                    limited. Instead, I will characterize it as thorough and efficient.

17                    Q. Do you have any other comments about the status of the applications in other  
18                    states?

19                    A. Yes I do. Mr. Robertson has included direct testimony from Office of the  
20                    Consumer Advocate witness Vitale (Schedule TJR-29.1 –29.19) but did not  
21                    include all of Aquila's rebuttal and supplemental testimony addressing Mr.  
22                    Vitale's issues. To avoid burdening the record with an overload of information  
23                    from the volume of rebuttal and supplemental testimony filed by Aquila, I have  
24                    attached as Surrebuttal Schedule JRE – 3), a copy of Aquila's Iowa Brief so that  
25                    the Commission can gain Aquila's perspective and have a complete picture.

1 **Conclusion**

2 Q. Do you have any concluding comments?

3 A. Yes. As I stated in my direct testimony and emphasize again now, Aquila  
4 understood the sensitivity that all of our state commissions might have about  
5 this request to use utility assets to secure utility debt. Aquila accepts full  
6 responsibility for its past business strategy, but is also working hard to restore  
7 financial stability without creating any financial or operational detriment to its  
8 utility customers. The direct and surrebuttal testimony provided by the Aquila  
9 witnesses in this case demonstrates that Commission approval of this  
10 application does not create any detrimental impact on the utility customers in  
11 Missouri. The five financial protections listed earlier and Aquila's commitment to  
12 maintain quality customer service and enhance regulatory transparency as  
13 outlined in my direct testimony are strong indicators of management's intent to  
14 protect utility customers from any potential adverse impacts during the transition  
15 back to an investment grade utility.

16 Q. Does this conclude your surrebuttal testimony?

17 A. Yes.

18

## Ring Fencing Mechanisms for Insulating a Utility in a Holding Company System<sup>1</sup>

### INTRODUCTION AND BACKGROUND

On March 27, 2003, in Reno, Nevada, the Subcommittee on Accounting and Finance (Subcommittee) initiated a project to study "ring fencing" mechanisms and how such mechanisms can affect utility regulation. This paper represents an analysis of our findings.

Ring fencing has been defined in different ways but generally involves techniques used to insulate the credit risk of an issuer from the risks of affiliate issuers within a corporate structure.<sup>2</sup> Our interests in this project are directed toward identifying and analyzing the various ring fencing mechanisms that can be employed to insulate the regulated utility from the business practices and credit risks of sometimes highly speculative, non-regulated affiliates.

The Subcommittee has addressed the interrelationship of regulated utilities and non-regulated affiliates before. First, in 1999, the Subcommittee developed "Guidelines for Cost Allocations and Affiliate Transactions" (Guidelines) for energy utilities, which were adopted by NARUC at its Summer Meetings, San Francisco, California July 22, 1999. The adopted Guidelines are intended to "provide guidance to jurisdictional regulatory authorities in the

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<sup>1</sup> Prepared by Timothy Devlin, Florida Public Service Commission, Rebecca Phillips, Kentucky Public Service Commission, and Thomas Ferris, Wisconsin Public Service Commission with the assistance of Chancy Bittner of the Iowa Utilities Board, David Hodgden and Joseph Buckley of the Ohio Public Utilities Commission, Charles Christiansen, California Public Utilities Commission, and Terri Carlock, Idaho Public Utilities Commission. This paper was prepared on behalf of the NARUC Staff Subcommittee on Accounting and Finance. Any views or opinion expressed by the authors are not necessarily those of NARUC, the Florida, Kentucky, and Wisconsin Public Service Commissions, or any other particular state utility regulatory commission.

<sup>2</sup> Bonelli, Sharon, Yee, Mona, CFA, and Lapson, Ellen, CFA (2003). Corporate Finance, Rating Linkage Within U.S. Utility Groups, Utilities, Holding Companies and Affiliates. Fitch Ratings: Global Power/North America Special Report, April 9.

development of procedures and the recording of transactions for services and products between a regulated entity and affiliates."<sup>3</sup> Essentially, these Guidelines address cross subsidization issues between affiliated companies.

Additionally, in 2000, the Subcommittee prepared a white paper, "Codes of Conduct Governing Competitive Market Developments in the Energy Industry: An Analysis of Regulatory Actions." The purpose of the White Paper was to study the various codes of conducts in place around the country and to analyze the application and effectiveness of the various components of such codes.

### CURRENT FINANCIAL ENVIRONMENT

Due to recent events in the energy industry, including the implosion of Enron in late 2001, investigations into the trading activities of numerous marketers and the general glut of electricity in the marketplace, there has been a general trend towards electric utility bond downgrades. These downgrades have been most notable for electric utility companies operating within larger corporate structures and for those operating in states that have, or are in the midst of, restructuring. Although utilities that remain fully bundled may not appear in and of themselves to be riskier, bond rating agencies are more inclined to rate utility bonds at a rating similar to that of its parent company.

Because of the recent trend of rating agencies to consolidate utilities and non-regulated affiliated companies when evaluating risks, there has been increasing concern over the impact of non-regulated ventures upon the utility's access to debt and equity capital and the corresponding cost of such capital as well as the prospect of the utility being pulled into bankruptcy by its

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<sup>3</sup> NARUC Resolution Regarding Cost Allocation Guidelines for the Energy Industry, dated July 22, 1999.

parent's insolvency. As a consequence, ring fencing techniques are gaining the regulator's attention.

### RING FENCING MECHANISM

There are several techniques that can be employed separately, or together, to insulate a utility from the risks of affiliate issuers within a holding company system. These include proactive regulatory oversight, financial restrictions, structural separations, and operational controls.<sup>4</sup>

In ring-fencing, a shell is built around the utility by employing techniques to create a "package of enhancements." According to Standard and Poor's (S&P), a properly structured package of enhancements consists of three elements:<sup>5</sup>

1. A special "Structure," often including a "special purpose entity," structured in a way that reduces the risk of a subsidiary being pulled into bankruptcy along with its parent.
2. A tightly drafted set of covenants, including dividend tests, negative pledges, non-petition covenants, prohibitions from creating new entities, restrictions on asset transfers and inter-company advances, that preserve the financial well-being and autonomy of the ring-fenced subsidiary.
3. The third element is collateral. If the debt is fully secured by a pledge of all or substantially all of the assets of the subsidiary, the parent, in principle, has less freedom to deal with the assets of the subsidiary.

According to Fitch,<sup>6</sup> "Financial restrictions imposed solely through internal corporate policies are a weaker method of isolating issuer risks relative to those mandated by law, regulation or contract because the corporation may adjust its policies at will. Nevertheless, corporate policies are helpful indicators of management intent. While there are cases in which a

<sup>4</sup> Bonelli, Yee, & Lapson, page 4.

<sup>5</sup> Venkataraman, Swami, Standard and Poor's (2003). Holding Company Diversification and Its Impact on Regulated Operations. Speech before the NARUC Staff Subcommittee on Accounting and Finance, Reno, Nevada, March 26.

<sup>6</sup> Bonelli, Yee, & Lapson, page 2.



financially stressed parent has extracted dividends, inter-company loans or assets from its regulated utility subsidiaries, there are numerous cases illustrating voluntary restraint by a financially stressed parent holding company. Xcel and Allegheny Energy are two recent examples of holding companies that have refrained from transactions that impair the financial condition of their utility subsidiaries.<sup>7</sup>

Structural separations are another way to insulate the utility from the risks of non-regulated affiliates. One such structural separation is multiple ownership. When a utility is controlled by at least two parents or is the subject of a joint venture, the financial problems of any one of the parents is less likely to have consequences for the credit quality of the utility. Generally, the utility will be better insulated if credible owners are on equal footing and are able to prevent each other from harming the credit quality of the utility.<sup>7</sup>

Holding Companies are generally structured in one of two ways. The first, more common structure, involves a nonregulated shell holding company, which owns the equity of both the regulated and nonregulated subsidiaries. In the second structure, the regulated utility operates as the parent holding company owning stock in various subsidiary companies.<sup>8</sup> It may prove to be easier to insulate a utility if it is held as a subsidiary in a holding company structure instead of a structure in which the utility holds the equity (and therefore the equity risk) of various subsidiaries.

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<sup>7</sup> Venkataraman.

<sup>8</sup> Bonelli, Yee, & Lapson, page 3.

In some instances, the utility is held as a division of a parent company, without a separate capital structure. In these instances, the regulator might want to consider requiring utility operations be held as a separate subsidiary instead of being operated as a division so that a clearly separate capital structure can be defined. As Fitch notes, the holding company structure aids in the construction of a strong ring fence. A regulated utility operating as a division of the parent company results in a higher risk profile for the utility than if held as a separate subsidiary.<sup>9</sup>

The final way to achieve insulation is the imposition of restrictions from the outside -- from regulation, or even legislation, particularly at the state level. The strongest form of regulatory insulation exist where there are tight, statute-based restrictions on cash and asset transfers coupled with active and pre-emptive oversight by the regulatory body.<sup>10</sup>

State Commissions generally have broad powers to protect utilities from any adverse actions of affiliated companies. Some of these powers are explicitly provided for by statute, including prohibitions on the use of debt for non-utility purposes and encumbering utility assets for non-utility purposes. The regulator might also be proactive in encouraging a properly structured package of ring-fencing enhancements as discussed above. That is to say, the regulatory entity might require the insertion of a special purpose entity between the utility and the holding company, structured in a way that reduces the risk of the utility being pulled into bankruptcy along with its parent or other affiliated company. This could also require a tightly drafted set of covenants subject to commission review.

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<sup>9</sup> Bonelli, Yee, & Lapson, page 3..

<sup>10</sup> Venkataraman.

Additionally, many Commissions have codified Codes of Conduct and Cost Allocation Rules as the energy market has evolved toward a more competitive market. Other tools employed by Commissions to safeguard utility assets have been established through Orders under the Commissions' broad power of ensuring that utilities provide safe, adequate, and reliable services at just and reasonable rates (or prices).

S&P states that "insulation brought about by legislative statutes is a great deal more certain than state utility commission rulemaking and will provide for greater ratings separation."

S&P also states that, "Notably, most state regulators maintain their state or commission has explicit laws or regulations in place that provide sufficient authority to prevent the financial condition of the utility from being adversely affected by the activities of nonregulated affiliates. However, from a credit perspective, Standard & Poor's believes most of these laws and regulations to be reactive measures; they do not prevent the diversified businesses from weakening the regulated business. These rules typically enable state regulators to take action only after the damage has occurred."<sup>11</sup>

In a recent presentation to the Subcommittee, S&P named three states that they believe have adequate regulatory insulation mechanisms. Interestingly, one example involves a Commission Order, not a definitive statute. These states and mechanisms are:<sup>12</sup>

1. The Wisconsin Commission has explicit statutes governing the energy utility/affiliate relationship. Statute 196.795(5)(g) requires that "no holding company system may be operated in any way which materially impairs the credit...of any public utility affiliate." Statute 196.795(5)(c) and (d) prohibit a utility from lending money to or guaranteeing any obligations of its parent holding company or any nonutility affiliates. Statute 196.795(6m)-Asset Cap, limits nonutility investments to 25 percent of public utility assets with certain exceptions. Statute

<sup>11</sup> Ferrara, William (2002). Research: Is State Utility Regulation Coming Back Into Vogue?. Standard & Poor's Ratings Direct, October 4.

<sup>12</sup> Venkataraman.

196.795(5) also includes provisions limiting subsidies between the utility and nonutility affiliates. Statute 196.52 relates to relations with affiliated interests and Commission control of affiliate contracts. Statute 196.80 requires Commission approval for an energy utility to merge, consolidate, acquire the stock of any other public utility, or sell, acquire, lease, or rent any public utility plant or property constituting an operating unit or system. Statute 196.795(3) regarding "takeovers" requires commission review and approval before allowing anyone to own more than 10 percent of the outstanding voting securities of the holding company. Statute 201.03 requires that utility security issuances be approved by the Commission prior to the issuance of such securities. The use of proceeds has to be related to utility operations. Finally, Statute 196.795(4), for utilities in an energy holding company system, and 201.11 authorize the Commission to order a utility to cease paying dividends on its common stock when there is a finding of capital impairment.

2. The Oregon Commission placed certain conditions in its Order approving the Portland General Electric Company (PGE)/Enron merger. Most notable, "PGE must maintain the common equity portion of its capital structure at 48% or higher unless the Commission approves a different level, and must notify the Commission of certain dividends and distributions to Enron." The 8-notch bond rating differential between PGE and Enron would seem to indicate successful ring fencing.
3. The Virginia Commission also has explicit statutes regarding utility/affiliate relationships. Chapter 3 (§56-58) of Title 56 of the Code of Virginia requires that utility security issuances be approved by the Commission prior to the issuance of such securities. The use of proceeds has to be related to utility operations. Additionally, Chapter 3 (§56-59) and Chapter 4 (§56-82) require that utilities, prior to assuming obligations as a guarantor, seek Commission approval for such guarantees. Chapter 4 (§56-82) requires utilities to gain Commission approval for affiliate loans. Chapter 4 (§56-83) authorizes the Commission, under certain circumstances, to prohibit a utility from paying dividends to an affiliate. Chapter 5 requires that prior to the change in ownership or control of: (1) a utility operating in Virginia, (2) any utility asset located in Virginia, or (3) utility securities occurs, Commission approval must be obtained. Under SEC Rule 53(c) of the Public Utility Holding Company Act, the Virginia Commission has been able to get utilities to agree that measures will be taken if bond ratings fall to certain levels. These conditions were based on the above mentioned statutes.

In summary, of the three states that S&P mentioned, two rely upon state statutes for their regulatory insulation. The third relied on conditions in a merger that indirectly is dependent upon state authority over mergers.

### FEDERAL ROLE

As noted by Fitch, the Public Utilities Holding Company Act of 1935 (PUHCA) has some positive effect on the credit quality of subject utilities by regulating holding companies on matters including company structure, intercompany loans, reporting, acquisitions, and issuance and sale of securities.<sup>13</sup> Furthermore, according to the American Public Power Association (APPA), the financial problems of many electric utilities and utility holding companies today can be traced directly to the partial repeal and weakened safeguards of PUHCA via the enactment of the 1992 Energy Policy Act.<sup>14</sup> If PUHCA is totally repealed despite concerns (as is being seriously considered), it becomes increasingly important for the states to augment their own ability to monitor and regulate holding companies.<sup>15</sup> There is some concern that the Commerce Clause could severely constrain the ability of a state to regulate a multi-state holding company.<sup>16</sup> In any case, the importance of oversight will only increase if the repeal sets off, as some expect, another major merger wave.

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<sup>13</sup> Bonelli, Yee, & Lapson, page 2.

<sup>14</sup> APPA, "The Public Utility Holding Company Act—Its Protections Are Needed Today More Than Ever," February 2003, p. 4.

<sup>15</sup> In this regard, also see the January 30, 2002, letter of John D. Dingell and Edward J Markey to Harvey L. Pitt; then Chairman of the SEC, at [http://www.house.gov/commerce\\_democrats/press/107ltr129.htm](http://www.house.gov/commerce_democrats/press/107ltr129.htm).

<sup>16</sup> Anderson, John, "Commentary: Pro & Con," Public Utilities Fortnightly, July 15, 1995, p. 38.

The Federal Energy Regulatory Commission (FERC) has recently undertaken steps to increase its active oversight of utility/holding company relationships for those utilities under its jurisdiction. These steps include an on-going rulemaking initiative into cash management practices<sup>17</sup> and a recent decision to impose new conditions to all future public utility issuances of secured and unsecured debt authorized by the commission. These conditions are:<sup>18</sup>

1. Public utilities seeking authorization to issue secured debt backed by a utility asset must use the proceeds of the debt for utility purposes only.
2. If any utility assets that secure debt issuances are "spun off," the debt must follow the asset and also be "spun off."
3. If any of the proceeds from unsecured debt are used for nonutility purposes, the debt must follow the nonutility assets. If the nonutility assets are "spun off," then a proportionate share of the debt must follow the "spun-off" nonutility asset.
4. If utility assets financed by unsecured debt are "spun off" to another entity, then a proportionate share of the debt must also be "spun off."

There is also an amendment to the national Energy Bill that addresses corporate and financial separation. If passed into law, this would presumably increase FERC's authority and articulate a needed mandate to protect public utilities from the financial distress caused by risky investments made by utility parent companies in nonutility businesses. However, the proposed legislation does not provide states with the additional authority needed to better ensure that consumers are protected from potential abuses by large, unrestricted holding companies. Such additional authority would include the right of the states to form joint oversight bodies to conduct financial and managerial audits of multi-jurisdictional utilities, including those operating within a larger corporate structure. This authority would provide for such audits and other oversight actions as states deem necessary with or without federal agency involvement.

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<sup>17</sup> FERC, "Regulation of Cash Management Practices," Docket No. RM02-14-000.

<sup>18</sup> FERC, "Commission Sets New Conditions for Utility Debt Acquisition," Docket No. ES02-51-000, News Release, February 20, 2003.

### RING FENCING AND BANKRUPTCY

As previously mentioned, ring fencing aids in protecting the utility from the financial problems of non-regulated affiliates. The extreme case would be one of bankruptcy. In California, Edison International and Pacific Gas & Electric Corp. attempted to protect its subsidiaries from insolvency by implementing the following ring fencing measures:<sup>19</sup>

1. Making certain subsidiaries into special purpose entities (SPE) or "limited purpose operating entities" similar to an SPE;
2. Providing a nonconsolidation opinion between subsidiary and parent (upon insolvency of the parent, the assets of the subsidiary would not be consolidated with the parent's);
3. Securing legal comfort that the ring-fencing did not contradict any law, regulation, order, or contract; and
4. Securing other legal comfort that the ring-fencing would not invoke any of the "recharacterization" provisions of the Federal Bankruptcy Code.

Since a parent may have the incentive to file a subsidiary utility into bankruptcy, there are other economic measures that could be undertaken. These include termination provisions in certain contracts (i.e. commodity hedge) in the event of non investment grade rating.

On April 23, 2003, several state commission staff members and analysts at Fitch discussed ring-fencing. Fitch pointed out there is no perfect ring fence that can completely insulate a utility. They question certain techniques such as the "golden share" where an independent director for a utility has certain powers. More importantly, according to Fitch, companies have an inalienable right to file a subsidiary into bankruptcy. A company cannot waive this right according to the General Counsel at Fitch. Regardless, Fitch mentioned several measures that aid in the insulation of the utility and include: (1) minimum equity ratio, (2) separate books and records, (3) separate subsidiaries, and (4) limitation on upstream loans.

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<sup>19</sup> Rigby, Peter (2001). Ring Fencing Subsidiaries From Parents' Bankruptcies in California. Standard & Poor's Project & Infrastructure Finance, October, 121-123.

The filing of a bankruptcy creates an automatic stay that halts all attempts by creditors to collect their claims from debtors. Creditors who willfully violate the automatic stay are subject to sanctions. However, federal, state and local government agencies are not subject to the automatic stay in the exercise of certain police or regulatory powers.<sup>20</sup> Regulatory actions of an economic nature would probably not be exempted from the automatic stay. Most state commission actions are of an economic nature and therefore, are mooted by bankruptcy filing.

### POSSIBLE RING FENCING MEASURES

While according to the ratings agencies, state statutory authority is the preferable tool to properly insulate the regulated utility from non-regulated affiliate activities, any action that state regulators take that provides support (whether legal, regulatory, financial, or operational) to the utility and/or isolates the utility (most importantly financial obligations) from its parent company will be positive from a credit rating standpoint. Only when sufficient regulatory insulations exist will the corporate credit rating (risk of default) of an operating company be separated from that of the holding company.<sup>21</sup>

To the extent permitted under its state statutes and depending on the specific circumstances, in any rate case proceeding, approval of mergers, approval of affiliated interest contracts, approval of securities, or any other similar proceedings, a state commission may want to consider ways to insulate a utility in a holding company system by restricting the flow of the utility's cash to its parent company, such as overhead

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<sup>20</sup> Overview of Bankruptcy and the Impact of Bankruptcy on the Regulatory Process, United States Trustee for Region 21, Northern District of Florida, Tallahassee, Florida.

<sup>21</sup> Ferrara.



allocation, loan and dividend restrictions, and stringent equity-maintenance requirements.<sup>22</sup>

The following are suggested areas to be considered ring fencing measures (some are more strenuous forms of others given):

1. Commission authority to restrict and mandate use and terms of sale of utility assets. This includes restriction against using utility assets as collateral or guarantee for any non utility business.
2. Commission authority to restrict dividend payments to a parent company in order to maintain financial viability of the utility. This may include, but is not limited to, maintenance of a minimum equity ratio balance.
3. Commission authority to authorize loans, loan guarantees, engagement in money pools and large supply contracts between the utility and affiliate companies.
4. Commission authority over the establishment of a holding company structure involving a regulated utility.
5. Expand commission authority over security applications to include the ability to restrict type and use of financing.

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<sup>22</sup> Ferrara.

**AQUILA, INC.**  
**CASE NO. EF-2003-0465**  
**DATA REQUEST NO. OPC-629**

**DATE OF REQUEST:** August 19, 2003  
**DATE RECEIVED:** August 19, 2003  
**DATE DUE:** September 3, 2003  
**REQUESTOR:** James Busch

**QUESTION:**

Please answer the following: 1) Does Aquila believe that being required to prepay for natural gas supplies and pipeline transportation capacity is a detriment to Aquila? 2) Does Aquila believe that being required to prepay for natural gas supplies and pipeline transportation capacity is a detriment to Aquila's customers? Please explain your answer. Please explain your answers.

**RESPONSE:**

1. No. While there is a financial impact on Aquila, it has not been detrimental to our ability to provide safe and reliable service to our customers.
2. No. There is no adverse financial impact on Aquila's customers.. The working capital is being funded from an "internal revolver" which would be considered short term debt. The use of this revolver is priced at a short term, investment grade rate. Aquila has also committed to using a lead-lag calculation in rate cases that would neutralize any potential impact of prepayment for gas supplies and pipeline capacity.

**ATTACHMENT:** None

**ANSWERED BY:** Carol Lowndes

---

**SIGNATURE OF RESPONDENT**

**AQUILA, INC.**

**CASE NO. EF-2003-0465  
DATA REQUEST NO. OPC-630**

**DATE OF REQUEST:** August 19, 2003  
**DATE RECEIVED:** August 19, 2003  
**DATE DUE:** September 3, 2003  
**REQUESTOR:** James Busch

**QUESTION:**

If either answer 1 or 2 to OPC DR No. 629 is negative, please explain why Aquila has not always prepaid for natural gas supplies and pipeline transportation capacity.

**RESPONSE:**

While there is not a detriment to Aquila's customers, there is an impact to the Company in terms of financial impact. There are incremental financing costs associated with prepaying for natural gas supplies and pipeline transportation capacity. However, Aquila has included these costs in its financial planning and this increase in costs has not and will not be translated into any cost to be borne by our customers and there has been no detrimental impact on the customers in terms of our ability to deliver safe and reliable service to customers.

**ATTACHMENT:** None

**ANSWERED BY:** Carol Lowndes

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**SIGNATURE OF RESPONDENT**

**AQUILA, INC.**  
**CASE NO. EF-2003-0465**  
**DATA REQUEST NO. OPC-632**

**DATE OF REQUEST:** August 19, 2003  
**DATE RECEIVED:** August 19, 2003  
**DATE DUE:** September 3, 2003  
**REQUESTOR:** James Busch

**QUESTION:**

Is there an opportunity cost to Aquila or its customers due to Aquila having to prepay for natural gas supplies and pipeline transportation capacity? Please explain your answer.

**RESPONSE:**

There is an opportunity cost to Aquila at this time due to the Company's current credit profile and its requirement to pre-pay for gas supply and transportation capacity. Transactions that require a company to pre-pay for goods or services will increase the time gap between cash outflow and inflow and the working capital requirements for that company.

While there are opportunity costs associated with having to make prepayments, Aquila has committed to using a lead-lag calculation in rate cases that would neutralize any potential impact of prepayment for gas supplies and pipeline capacity and will not be translated into any cost to be borne by our customers.

**ATTACHMENT:** None

**ANSWERED BY:** Mike Cole

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**SIGNATURE OF RESPONDENT**

**AQUILA, INC.**  
**CASE NO. EF-2003-0465**  
**DATA REQUEST NO. OPC-633**

**DATE OF REQUEST:** August 19, 2003  
**DATE RECEIVED:** August 19, 2003  
**DATE DUE:** September 3, 2003  
**REQUESTOR:** James Busch

**QUESTION:**

If there are opportunity costs, please provide the Company's calculation of the opportunity costs.

**RESPONSE:**

Two methods of calculating Aquila's opportunity costs seem most appropriate. The incurrence of this opportunity cost is centered on the fact that natural gas pre-payment requirements temporarily reduce Aquila's cash balance. The first method focuses on the investment rate currently earned on our cash balances and estimates the opportunity cost of foregoing this interest income during the pre-payment period. If Aquila pre-pays \$10 million one month in advance, then the foregone interest income would be about \$12,500. A second method of estimating the opportunity cost is to calculate the foregone economics of Aquila using the cash needed for the prepayment for other purposes. While the first example focused on short-term cash investments, this method assumes that the cash is invested at Aquila's overall cost of capital of [8.16]% and [8.3]% for MPS and SJLP, respectively. If Aquila pre-pays \$10 million one month in advance, then the opportunity cost using this method would be about \$68,500.

While there are opportunity costs associated with having to make prepayments, Aquila has committed to using a lead-lag calculation in rate cases that would neutralize any potential impact of prepayment for gas supplies and pipeline capacity and will not be translated into any cost to be borne by our customers.

**ATTACHMENT:** None

**ANSWERED BY:** Mike Cole

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**SIGNATURE OF RESPONDENT**

STATE OF IOWA  
DEPARTMENT OF COMMERCE  
UTILITIES DIVISION  
BEFORE THE UTILITIES BOARD

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IN RE: )  
 ) DOCKET NO. SPU-03-7  
 )  
AQUILA, INC. d/b/a )  
AQUILA NETWORKS )  
 )

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INITIAL BRIEF  
OF  
AQUILA, INC. d/b/a AQUILA NETWORKS

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September 12, 2003

TABLE OF CONTENTS

I.	STATEMENT OF THE CASE .....	1
A.	Course of Proceedings .....	1
B.	Description of Proposed "Reorganization" Transaction .....	3
1.	Debt Reduction and Financial Restructuring Plan .....	3
2.	Utility Working Capital Requirements .....	6
3.	Three-Year Term Loan .....	7
C.	Description of Relief Requested .....	10
D.	Applicable Law .....	11
II.	ARGUMENT .....	13
A.	Consideration of each of the five statutory factors relevant to the Board's review of Aquila's application in this case warrants a Board decision not to disapprove the proposed pledge of Aquila's Iowa utility assets. ....	13
1.	Aquila's ratepayers will not be detrimentally affected by the proposed pledge of Iowa utility assets .....	14
2.	The public interest will not be detrimentally affected by the proposed pledge of Iowa utility assets .....	20
3.	The ability of Aquila to provide safe, reasonable, and adequate service will not be impaired by the proposed pledge of Iowa utility assets .....	21
4.	Aquila's ability to attract capital on reasonable terms, including the maintenance of a reasonable capital structure, will not be impaired by the proposed pledge of Iowa utility assets .....	23

5.	The Board will continue to have reasonable access to the books, records, documents and other information relating to Aquila .....	24
B.	The Board should reject the OCA's suggestion that Aquila be required to establish a holding-company structure as a condition of the Board's approval of Aquila's proposal to pledge its Iowa utility assets .....	26
III.	CONCLUSION .....	31



This is the initial brief of Aquila, Inc. d/b/a Aquila Networks ("*Aquila*") in this proceeding to review Aquila's request for authority to pledge its Iowa utility assets to secure debt incurred by Aquila for the purpose of providing adequate working capital for its utility operations.

## **I. STATEMENT OF THE CASE**

### **A. Course of Proceedings**

On April 30, 2003, Aquila filed with the Board an application for approval of a proposal for "reorganization" in compliance with the requirements of Iowa Code §§ 476.76, 476.77 and 199 IAC ch. 32. On May 2, 2003, the Board issued an order docketing the application as a contested case identified as Docket No. SPU-03-7. A subsequent order issued on May 21, 2003, established a procedural schedule for the case. In an order issued on June 13, 2003, the deadline for Board action on Aquila's application was deferred from July 29, 2003, to October 27, 2003, pursuant to the authority conferred on the Board by Iowa Code § 476.77.

Aquila filed direct written testimony along with its initial application on April 30, 2003. On June 2, 2003, the OCA filed its written direct testimony. Aquila's written rebuttal testimony was filed shortly thereafter on June 13, 2003. In an order issued July 3, 2003, the Board directed both Aquila and the OCA to submit additional written testimony responding to forty-three questions listed in the order. Additional written responsive testimony was filed by both parties on July 18, 2003.

The parties engaged in extensive discovery in the form of written data requests. Aquila responded to 153 separate OCA data requests served on Aquila from May 7 through August 12, 2003.

On August 26, 2003, an evidentiary hearing was conducted for the purposes of allowing parties to present additional oral testimony and giving the parties and the Board an opportunity to cross-examine all witnesses. Aquila presented five witnesses at the proceeding, each of which had filed written testimony prior to the hearing: Jon Empson; Benjamin Mann; Beth Armstrong; Rick Dobson; and Ivan Vancas. Each Aquila witness presented oral testimony at the hearing in response to some of the additional written testimony the OCA filed on July 18, 2003.

Jon Empson is Senior Vice President of Regulatory, Legislative, and Gas Supply Services for the Aquila Networks business unit. *Tr. 11.* Mr. Empson was Aquila's primary policy witness in this proceeding. He testified at a policy level about virtually all facets of Aquila's application and the transaction at issue in the proceeding, including but not limited to the broad financial, economic, and public policy issues implicated in the case. One important focus of his testimony was to explain the internal allocation and operational controls Aquila has put in place to ensure that Aquila's Iowa ratepayers are protected from potential adverse financial impacts. *Tr. 12-15; 43-47.*

Benjamin Mann is an attorney and partner in the Kansas City office of the law firm of Blackwell Sanders Peper Martin LLP. *Tr. 85.* Mr. Mann was presented as an expert witness on bankruptcy law,<sup>1</sup> and testified on issues relating to bankruptcy and to structural protections in a bankruptcy context. *Tr. 85-86, 105-106, 114-116, 30.*

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<sup>1</sup> The OCA, on the other hand, did not offer any expert bankruptcy law testimony in this case. *Tr. 322-323.*

Beth Armstrong is Chief Financial Officer of U.S. Networks<sup>2</sup> for Aquila. *Tr. 124*. Ms. Armstrong testified about certain details of the derivation of Aquila's working capital requirements as set forth in Aquila's application. *Tr. 125, 29*.

Rick Dobson is Senior Vice President and Chief Financial Officer for Aquila. *Tr. 166*. Mr. Dobson's testimony focused on Aquila's financial condition and plan, the role a certain three-year term loan agreement<sup>3</sup> plays in that financial plan, and why the specific transaction for which Aquila is seeking Board approval in this proceeding – the pledge of Iowa utility assets as collateral to support the loan – is necessary and does not detrimentally affect Aquila's ratepayers. *Tr. 167, 29*.

Ivan Vancas is Operating Vice President for Aquila's gas distribution properties located in Iowa and Missouri. *Tr. 238*. His testimony was confined to service quality issues raised by the Board in some of the questions posed in the order issued July 3, 2003. *Tr. 238-239*.

**B. Description of Proposed "Reorganization" Transaction**

**1. Debt Reduction and Financial Restructuring Plan**

The pledge of Iowa utility assets at issue in this proceeding is one piece of an overall debt reduction and financial restructuring plan Aquila has developed and is in the process of implementing. *Tr. 175; Exh. 114*. At the outset, then, it is important to understand exactly why Aquila found it necessary to develop and undertake a plan of such major proportions.

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<sup>2</sup> "U.S. Networks" refers to the aggregation of operating divisions of Aquila's domestic utilities in the various states. *Tr. 125*.

<sup>3</sup> This three-year term loan is discussed in detail in section I.B.3. below.

The plan itself succinctly states the reasons the plan was undertaken:

As the energy merchant sector has deteriorated during the past year with the collapse of Enron and the problems in the California electric markets, investors have experienced a crisis in confidence and have largely fled the industry. In response, the credit agencies, seeking to protect future investors, have significantly increased the credit hurdles that must be met going forward for all of the merchant players. With its diversified business mix, existing size and credit rating, Aquila could not obtain nor sustain the level of liquidity now required to be a viable energy merchant company and was forced to exit the business.

*Exh. 114, p. 2.* This understanding of the cause of the financial situation facing Aquila at that time is shared by the staff of the Missouri Public Service Commission, which concluded in a report dated December 2002:

The financial collapse of Enron saw the beginning of significant impacts on the utility industry and, specifically, certain electric companies. Aquila was a company that was significantly impacted following Enron's financial demise.  
\* \* \* Credit rating agencies established higher financial thresholds for investment-grade companies after Enron's collapse. Aquila determined that under the new market conditions and more stringent requirements recently established by credit rating agencies, it did not have sufficient liquidity to continue in the trading business in its Energy Merchant Business segment.

*Exh. 106, p. 8.*

The OCA witness erroneously claimed in this case that the problems the plan is designed to address are the "result of losses in [Aquila's] unregulated operations." *Tr. 273.* However, as explained in the preceding paragraph, it was dramatic and sudden changes in credit requirements associated with operating a merchant business, not losses in Aquila's unregulated operations, that created the financial situation the debt reduction and financial restructuring plan was developed to address. *Tr. 24.* The fact of the matter is that fully half of Aquila's earnings before interest and taxes (EBIT) came from Aquila's global networks and energy merchant operations in 2001. *Tr. 169.* The Enron debacle and the California energy crises led to the rapid collapse of the

energy merchant sector in early 2002. *Tr. 169.* The reaction of the credit rating agencies to those events was to impose new, more stringent credit guidelines on those companies (including Aquila) still left in the energy merchant sector. *Tr. 170.* The credit rating agencies raised the requirements for liquidity and balance sheet strength for merchant companies to a level that Aquila could not meet or sustain on an ongoing basis. *Tr. 170.* As a result, on August 6, 2002, in the middle of a year in which Aquila had planned to assume a stronger and even leading role in the energy merchant industry, Aquila was instead compelled to announce its decision to exit the merchant business as market conditions continued to deteriorate in that industry. *Tr. 170-171.*

The first phase of Aquila's debt reduction and financial restructuring plan has been completed. *Exh. 114, pp. 3-5.* During this initial phase, Aquila focused on selling its most liquid non-strategic assets and reducing associated liabilities and debt. *Exh. 114, p. 2.* This phase also involved a program to reduce unnecessary operating expenses and to refocus Aquila's operations on the domestic network business. *Exh. 114, p. 2.* Since the middle of 2002, Aquila has in fact closed its merchant trading operations, sold \$1.3 billion in assets, reduced its debt by over \$1.0 billion, and eliminated its common stock dividend. *Tr. 172; Exh. 114, p. 2.*

The second phase of the plan will involve further reduction of liabilities by selling Aquila's remaining international and non-core domestic assets, buying out certain tolling contracts, restructuring other liabilities, and ensuring that Aquila's utility business and customers are not adversely affected by implementation of the plan. *Exh. 114, p. 2; Tr. 174.* The plan calls for Aquila to exit all non-utility business to the point where Aquila will eventually own and operate only domestic utility businesses. *Tr. 21, 49.* Upon completion of the plan, Aquila will

be a “domestic utility company” with gas and electric operations and an integrated on-system appliance repair business. *Tr. 50-51; Workpapers Supporting Vitale Additional Testimony, “Aquila’s Annual Shareholders Meeting – June 4, 2003,” p. 10.*

## 2. Utility Working Capital Requirements

In order to gain the time necessary to implement fully the second phase of Aquila’s plan, Aquila had to obtain access to sufficient liquidity by means of a new working capital facility. *Exh. 114, p. 2.* The rapid sale of assets, the recognition of the accompanying book losses, and the reduction in the scope of Aquila’s business activities involved in the first phase of the plan violated certain interest coverage ratio covenants in Aquila’s bank revolving credit facilities. *Tr. 173; Exh. 114, p. 6.* In order to avoid mandatory repayment of the loans, Aquila sought and received waivers from the banks, but the waivers and the bank revolvers expired on April 12, 2003. *Exh. 114, p. 6.* As a result, Aquila had to enter into a new debt agreement no later than April 12 to provide itself with working capital sufficient to allow it to maintain its ongoing business and complete the implementation of its debt reduction and financial restructuring plan. *Tr. 174.*

Aquila has determined that \$250 million is needed to support the ongoing working capital requirements of its domestic utility business. *Tr. 175.* This determination is the result of an internal study of Aquila’s domestic utility working cash needs using detailed budget information supporting the plan. *Tr. 176.* The methodology, assumptions, and results of the study are summarized in the testimony of Aquila witness Dobson (*Tr. 176-177*) and described in detail in one of his exhibits (*Exh. 116*). Aquila witness Armstrong, who performed the study

under the direction of Mr. Dobson, provided additional detail about the assumptions, methodology, and results of the study. *Tr. 125-131, 135-143; Exh. 112.* On the basis of that study, Aquila has reasonably concluded that liquidity capacity of at least \$250 million is necessary to adequately protect Aquila's domestic utility business. *Tr. 177, 131.* As an additional measure of reasonableness, Aquila has offered an analysis in this proceeding showing that on a relative basis the amount of liquidity Aquila has determined to be necessary is not excessive.<sup>4</sup> *Tr. 178; Exh. 117.*

### 3. Three-Year Term Loan

On April 11, 2003, Aquila succeeded in replacing its expiring revolving credit facilities and loan waivers with two new debt instruments: a \$430 million three-year term loan, and a \$100 million 364-day loan. *Tr. 174.* The primary purpose of the latter loan is to give Aquila an "advance" on the sale of its Australian assets in order to retire outstanding debt. *Tr. 174.* The purpose of the three-year term loan is to meet Aquila's ongoing working capital needs for all of its operations, including the \$250 million required for its domestic utility operations. *Tr. 176.*

Prior to April 11, 2003, Aquila had two revolving credit facilities due to expire on April 12: a three-year revolving credit facility with an outstanding balance of approximately \$190.2 million, and a 364-day revolving credit facility with an outstanding balance of \$227 million. *Tr. 185.* The cash from the expiring facilities – amounting in total to \$417.2 million – was already recorded on Aquila's balance sheet. *Tr. 387.* The cash Aquila received from the new three-year

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<sup>4</sup> This level of utility working capital has also been accepted by the Colorado Public Service Commission. *Tr. 36; Exh. 101.* It was also deemed "reasonable" by a Minnesota Department of Commerce analyst in comments submitted to the Minnesota Public Utilities Commission on June 30, 2003. *Tr. 36.*

term loan was used to pay off the expiring credit facilities, which allowed Aquila to retain the \$417.2 million in cash on its balance sheet for working capital purposes. *Tr. 387*. The new three-year term loan will be held by Aquila at the corporate level and the funds will be used as if a revolver existed; *i.e.*, Aquila will function as the bank for the business operations. *Tr. 178*. What Aquila effectively accomplished with the new three-year term loan, then, was to substitute for the two expiring revolving credit facilities a new facility that, though not formally revolving, replaces and serves the same function as the expiring revolvers. *Tr. 387*. As a result, the full \$430 million amount of the three-year term loan is available to meet Aquila's working capital needs during its financial restructuring.<sup>5</sup>

The \$430 million three-year term loan was initially secured with collateral from Aquila's Nebraska and Michigan domestic utilities, a pledge of the capital stock of the holding company for Aquila's Canadian utilities, and a silent second lien on the equity interest in the holding company of Aquila's IPP investments. *Tr. 35-36, 174*. Based on the principles used by the lending institutions, however, the domestic utility assets in Nebraska and Michigan were not sufficient in value to support the \$250 million of the loan required to meet the working capital requirements of Aquila's domestic utilities. *Tr. 175*. As a result, the Canadian investment provided a portion of the required collateral for the \$250 million utility requirement. *Tr. 175; Exh. 115*.

However, Aquila firmly believes that it is both necessary and appropriate to maintain a proper alignment of domestic utility collateral with domestic utility working capital needs, on the

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<sup>5</sup> There appeared to be some confusion about this fact at the hearing, which apparently led to a mistaken conclusion that only \$10.8 million of the proceeds of the new three-year loan is available to provide working capital. *Tr. 350-353*.



one hand, and nonregulated business collateral with nonregulated business working capital needs, on the other. *Tr. 36, 176*. Utility assets should support the working capital requirements for the utility operations. *Tr. 36, 176*. In addition, when the Canadian investment is sold (as contemplated by Aquila's plan), Aquila is required by the terms of the three-year term loan agreement to use all of the proceeds of the sale to repay the term loan to the point where the remaining *utility* collateral value equals or exceeds 167% – or total collateral equals or exceeds 200% if that amount is greater – of the then-outstanding term loan balance. *Tr. 176, 184-185; Exh. 201, Sched. A, p. 37, art. 2.7(y)*. In addition, the borrowing rate under the three-year term loan agreement drops 75 basis points – from 8.75% to 8.0% – when Aquila adds sufficient utility collateral to the pool securing the loan. *Tr. 36, 176*.

The use of secured debt was the only option available to Aquila to raise the funds it needs to support ongoing operations. *Tr. 27, 179*. The OCA has taken the position in this case that options other than secured debt were available for funding Aquila's working capital requirements; namely, the issuance of new common equity, the sale of accounts receivable, the rescheduling, alteration, or abandonment of nonessential capital projects, and the sale of additional utility assets. *Tr. 289*. As Aquila witness Dobson explained, however, although the options identified by the OCA may have been theoretically available to Aquila, as a practical matter they were wholly infeasible at the time. *Tr. 200-203*.

The use of secured debt by a utility is neither unusual nor uncommon. *Tr. 27, 179-180*. In the early 1990s, it was a common occurrence for utilities to issue secured debt. *Tr. 179; Exh. 118*. From January 2002 through the first quarter of 2003, there were forty separate issuances of secured debt, totaling \$12.4 billion, by both investment-grade and non-investment-grade utilities.

*Tr. 179; Exh. 119.* Aquila's predecessor, UtiliCorp, used secured debt to permanently finance its purchase of Peoples Natural Gas in 1986. *Tr. 180; Exh. 120.* Another Iowa utility, Alliant Energy, has secured debt collateralized by "substantially all tangible public utility property of IP&L."<sup>6</sup> *Tr. 22.*

Aquila has filed applications similar to the one before the Board in this case in four other states: Colorado, Minnesota, Kansas, and Missouri. *Tr. 30.* The Colorado application has already been approved. *Tr. 32.* If no states other than Colorado approve the proposed pledge of utility assets located in their respective states, at such time as all nonregulated assets are sold and thus unavailable as collateral Aquila will realign the loan to match the available collateral and, if necessary, maintain sufficient cash on its balance sheet to meet peak working capital requirements. *Tr. 32.* This would inhibit Aquila's ability to retire debt with proceeds from asset sales, rendering the planned transition to an investment-grade utility more difficult and problematic. *Tr. 32.* In sum, though the success of that transition is not dependent on a single state, if all states deny the applications, then Aquila's financial plan cannot be executed as written. *Tr. 32.*

### **C. Description of Relief Requested**

In this proceeding, Aquila is asking the Board to grant relief primarily in the form of an order declining to disapprove Aquila's proposed pledge of its Iowa utility assets as collateral to support the three-year term loan. *Tr. 166-167.* In the event the Board decides to grant such

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<sup>6</sup> Even OCA witness Vitale's exemplary utility, Portland General, is using its utility property to secure the debt necessary to support both its short- and long-term needs. *Tr. 34.*

relief, Aquila is further requesting the Board to determine that such pledge may extend to any future extension or rollover of the three-year term loan and future replacement debt offerings for the working capital requirements of Aquila's domestic utility operations.<sup>7</sup> *Tr. 182, 198-199.*

This further action by the Board will maintain continuity in Aquila's financial liquidity, avoid the creation of another "financial deadline" that confers a negotiating advantage on lenders, and provide longer-term financial stability for the benefit of Aquila's ratepayers, employees, suppliers, and shareholders. *Tr. 198-199.*

**D. Applicable Law**

Iowa Code § 476.77 provides that a public utility "reorganization" shall not take place if the Board *disapproves*, and that a proposal for reorganization is "deemed to have been approved" by operation of law unless the Board disapproves the proposal within 90 days (or, for good cause shown, up to 180 days) after filing. For purposes of this provision, "reorganization" is defined as including the "acquisition, sale, or lease, or any other disposition, either directly or indirectly, including by merger or consolidation, of the whole or any substantial part of a public utility's assets." Iowa Code § 476.76.

Section 476.77 mandates that, prior to any such public utility reorganization, the utility file for Board review a proposal for reorganization. The utility is required by the same statute to "establish that the reorganization is not contrary to the interests of the public utility's ratepayers

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<sup>7</sup> After the three-year term loan expires, Aquila intends to continue with a working capital debt instrument secured by utility assets, but always aligned so that utility assets are only supporting utility working capital needs. *Tr. 178.* At the present time, Aquila anticipates that the three-year term loan could be maintained as an ongoing working capital debt instrument; however, it is difficult to predict what financial instruments might be available to Aquila when the three-year term loan expires. *Tr. 178.*

and the public interest.” The utility is *not* required, however, to show that the reorganization promotes or furthers the interests of its ratepayers or the public interest. During its review of a reorganization proposal, the Board is authorized by Section 476.77 to consider the following factors:

- (1) Whether the Board will have reasonable access to the books, record, documents, and other information relating to the public utility.
- (2) Whether the public utility’s ability to attract capital on reasonable terms, including the maintenance of a reasonable capital structure, is *impaired*.
- (3) Whether the ability of the public utility to provide safe, reasonable, and adequate service is *impaired*.
- (4) Whether ratepayers are *detrimentally affected*.
- (5) Whether the public interest<sup>8</sup> is *detrimentally affected*.

Iowa Code § 476.77(3) (emphasis added).

Significantly, although Section 476.77 grants the Board the authority to *disapprove* a utility reorganization, it confers neither the general authority to *approve*, nor the specific authority to *conditionally approve* (*i.e.*, approve with conditions), a utility reorganization. Aquila is aware of no Board decisions in which the Board has *approved* a utility reorganization, either with or without conditions.

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<sup>8</sup> “Public interest” is defined by the Board as “the interest of the public at large, separate and distinct from the interest of the public utility’s ratepayers.” 199 IAC § 32.4(4)“c”.

## II. ARGUMENT

Review and consideration of each of the five statutory factors established by Iowa Code § 476.77(3) compels the Board to decide not to disapprove the proposed pledge of Aquila's Iowa utility assets to support the three-year term loan. The Board's "approval" of the pledge of assets cannot and should not be conditioned on Aquila's establishment of a holding-company structure.

**A. Consideration of each of the five statutory factors relevant to the Board's review of Aquila's application in this case warrants a Board decision not to disapprove the proposed pledge of Aquila's Iowa utility assets.**

Aquila's ratepayers will not be detrimentally affected by the proposed pledge of Iowa utility assets. The record is devoid of any evidence that the pledge of assets will have any adverse effect on the interest of the public at large considered as separate and distinct from Aquila's ratepayers. On the contrary, the evidence shows that denial of Aquila's application to pledge its Iowa utility assets creates the potential to detrimentally affect the public interest.

The proposed pledge will not impair Aquila's ability to provide safe, reasonable, and adequate service. Aquila's ability to attract capital on reasonable terms, including the maintenance of a reasonable capital structure, will likewise not be impaired by the pledge. Finally, the Board will continue to have reasonable access to the books, records, documents, and other information relating to Aquila.

**1. Aquila's ratepayers will not be detrimentally affected by the proposed pledge of Iowa utility assets.**

Aquila made a commitment in this proceeding and in its debt reduction and financial restructuring plan to protect utility customers from potential adverse financial impacts associated with implementation of the plan. *Tr. 12*. This commitment extends to the proposed pledge of Iowa utility assets that, as explained in a prior section of this brief, is an essential part of the execution of the plan. In order to accomplish this, Aquila made two further specific commitments: (1) to maintain Aquila's capital allocation process, which utilizes hypothetical capital structures and long-term debt assignments; and (2) to ensure that all utility customers in Iowa pay rates based on new or replacement debt as if such debt were investment grade. *Tr. 12, 55-56; Exh. 114, p. 3*.

Aquila's capital allocation process, which has been in place since 1988 and has been presented to the Board by Aquila in every Aquila rate case since 1988,<sup>9</sup> is an internal "ring-fencing" mechanism<sup>10</sup> designed to insulate Aquila's utility operations from the risks of its non-utility businesses. *Tr. 12-13*. Aquila's regulated utility operating units receive capital based on what a comparable utility would experience. *Tr. 13*. Each business unit is internally financed with the proper mix of capital reflecting economic activities, profiles, and market-based comparative capital structures. *Tr. 13*. The hypothetical capital structure initially assigned by the capital allocation process to gas distribution was 50% equity and 50% long-term debt. *Tr. 13*.

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<sup>9</sup> Indeed, Aquila has proposed the use of such a hypothetical capital structure in every rate case since 1988 in each of the seven states in which it does business. *Tr. 25*.

<sup>10</sup> As defined by Mr. Empson, a "ring-fencing" mechanism is a technique used to insulate a utility business from nonregulated businesses from a credit, financial, and operational perspective. *Tr. 39, 79-80*.

The hypothetical capital structure initially assigned to electric distribution was 47.5% equity and 52.5% long-term debt. *Tr. 13*. Specific debt issuances are then assigned, based on need, to those specific business units that receive the proceeds until such time as the debt is retired. *Tr. 13*. Regulators and regulatory agencies in Minnesota, Kansas, Missouri, and Colorado have acknowledged Aquila's capital allocation process to be an effective mechanism to help shelter utility operations from non-utility operations. *Tr. 13-14, 25-27*.

Aquila intends to maintain this same capital allocation process, including the comparable company debt/equity ratios and the current long-term debt assignment process, during the tenure of its debt reduction and restructuring plan, including the term of the three-year term loan. *Tr. 15*. Aquila has not attempted – and during that period will not attempt – to allocate more debt to its utility operations than what can be supported by its comparable-utilities analysis. *Tr. 15*. When Aquila retires debt currently assigned to utility operations and replaces it with new debt, utility customers will be charged debt costs that reflect representative costs for comparable utilities having an investment-grade credit rating. *Tr. 15, 178*. The difference between the investment-grade cost and the actual cost of the debt will be retained at the corporate level. *Tr. 178*. By proceeding in this manner, Aquila is sheltering the utility customer from the cost of working capital to the extent that cost might exceed investment-grade levels. *Tr. 178*.

At the hearing, Aquila witness Empson further explicated Aquila's internal ring-fencing mechanism in light of a recent paper entitled "Ring Fencing Mechanisms for Insulating a Utility in a Holding Company System" prepared by the NARUC Subcommittee on Accounting and Finance.<sup>11</sup> *Tr. 40-47*. As the Board Chair pointed out during the hearing, the ring-fencing paper

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<sup>11</sup> A copy of the paper was introduced into the record as Exhibit 109. *Tr. 40*.

“takes no positions” and is merely an “informational” paper detailing the different ring-fencing measures that have been used across the country. *Tr.* 7. It is this objective, descriptive feature of the ring-fencing paper that prompted Aquila to use it to illuminate some of the salient features of Aquila’s internal ring-fencing mechanisms. *Tr.* 42.

Mr. Empson began his exposition with a brief discussion of the following statement from the ring-fencing paper: “Although utilities that remain fully bundled may not appear in and of themselves to be riskier, bond rating agencies are more inclined to rate utility bonds at a rating similar to that of its parent company.”<sup>12</sup> *Exh. 109, p. 2.* This statement runs contrary a major OCA position in this proceeding; namely, the claim<sup>13</sup> that a holding-company structure insulates a utility’s credit rating from the credit rating of its unregulated affiliates. *Tr.* 41-43.

The ring-fencing paper quotes one rating agency (Fitch) for the proposition that, although internal corporate policies may be a weaker ring-fencing method than legal, regulatory, or contractual mechanisms, nevertheless “corporate policies are helpful indicators of management intent.” *Exh. 109, p. 3.* According to the paper, Fitch went on to discuss the “numerous cases illustrating voluntary restraint” by a stressed company. *Exh. 109, pp. 3-4.* Mr. Empson testified to the relevance of these observations to his direct written testimony about the commitments that Aquila has made to provide internal financial and operational protections to its Iowa customers. *Tr.* 43-44.

Mr. Empson mentioned that there has been substantial debate in this case about the “best” method of ring-fencing, and in that context referred the Board’s attention to the following

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<sup>12</sup> In the same vein, the very next sentence of the ring-fencing paper refers to “the recent trend of rating agencies to consolidate utilities and non-regulated affiliated companies when evaluating risks.” *Exh. 109, p. 2.*

<sup>13</sup> See, e.g., *Tr.* 276, 287, 297.



discussion in the ring-fencing paper:

On April 23, 2003, several state commission staff members and analysts at Fitch discussed ring-fencing. Fitch pointed out that there is no perfect ring fence that can completely insulate a utility. \* \* \* [A]ccording to Fitch, companies have an inalienable right to file a subsidiary into bankruptcy. A company cannot waive this right according to the General Counsel at Fitch.

*Tr. 44; Exh. 109, p. 10.* Mr. Empson expressed his agreement with the Fitch observation that the search for a “perfect” ring fence in this case is futile and his belief that “what we need to do now is show what the intent of the company is and how they’re behaving in this environment to protect its customers.” *Tr. 45.*

Mr. Empson concluded his review of the ring-fencing paper with a discussion of five ring-fencing measures the paper proposes for consideration. *Tr. 45; Exh. 109, p. 12.* He testified that Aquila has made commitments to implement virtually all of these measures as a matter of internal corporate policy and practice. *Tr. 45.* Although Aquila does not have a holding-company corporate structure, it attempts to behave as if it did by the use of internal mechanisms that isolate risk and insulate Aquila’s customers. *Tr. 45.* With respect to the pledge of utility assets at issue in this proceeding, Aquila has committed to aligning collateral with need, so that utility collateral supports utility needs and non-utility collateral supports non-utility needs. *Tr. 45.* Aquila has committed to maintain a hypothetical capital structure and appropriate level of debt and equity for its utility operations based on comparable utilities. *Tr. 46.* For three years now, Aquila has maintained a detailed affiliate transactions manual to govern the pricing of goods and services passing between utility and affiliate operations. *Tr. 46.* The Federal Energy Regulatory Commission has already established and imposed standards on all new issuances of debt and equity and how that debt and equity can be used. *Tr. 47; Exh. 104.* Aquila’s proposed

pledge of utility assets is in compliance with these standards. *Tr.* 35-37.

A recurring theme of the OCA's testimony is that Aquila's proposed pledge of its Iowa utility assets will harm customers because they allegedly will be worse off in the event of an Aquila bankruptcy than they would be had those assets not been pledged. *See, e.g., Tr.* 275, 289-291, 307-309, 316-317, 319-320. OCA witness Vitale contends, for example, that if the proposed pledge of Iowa utility assets is allowed and Aquila subsequently files for bankruptcy, the secured claims of Aquila's lenders will come ahead of Iowa customer claims to their deposits. *Tr.* 275. According to Mr. Vitale, "Iowa utility customers could lose more than \$500,000 in deposits and funds if Aquila declares bankruptcy and their claims are treated like other unsecured creditors." *Tr.* 275.

Aquila witness Mann – the only bankruptcy law expert testifying in this proceeding – exposed the fallacies and errors inherent in the OCA's position on this issue, and demonstrated that the proposed pledge of utility assets will not have a detrimental effect on Aquila's customers in the event of an Aquila bankruptcy. Mr. Vitale's contention that the secured claims of Aquila's lenders will have precedence over the claims of Aquila's Iowa customers for deposits is simply wrong. *Tr.* 86. The agreements between Aquila and the lenders expressly provide that the lenders do not have a security interest in Aquila's cash or cash equivalents in funds deposited in bank accounts. *Tr.* 86-87; *Exh.* 110. Consequently, in the event of an Aquila bankruptcy, Aquila will be able to use its cash assets to satisfy the claims of its Iowa utility customers for deposits without regard to satisfaction of the lenders' secured claims out of the proceeds of property in which the lenders do have a security interest. *Tr.* 87, 94.

Mr. Vitale also got it completely wrong when he testified that in a bankruptcy the deposits of Iowa utility customers are treated like the claims of other unsecured creditors and could be lost. *Tr. 86*. Section 507 of the Bankruptcy Code grants customer deposits a priority to the extent of \$2,100 per customer. *Tr. 87, 94, 101-102*. This means that each customer deposit of \$2,100 or less would have to be satisfied in full upon confirmation before any distribution could be made to Aquila's general unsecured creditors. *Tr. 87, 94, 96*. In addition, Section 1129 of the Bankruptcy Code requires that in order for a reorganization plan to be confirmed by the bankruptcy court, the plan must provide for the payment in full of all Section 507 priority claims, which would include customer deposits. *Tr. 103*. Thus, Aquila could not emerge from a Chapter 11 bankruptcy without providing for repayment of customer deposits. *Tr. 96, 104*. Mr. Mann further testified that in all his experience as a bankruptcy attorney he has never heard of a bankruptcy court's refusing to allow the return of customer deposits. *Tr. 105-106, 114-115*.

During questioning by the Board, Aquila witness Empson testified that the effect on Iowa customers will not change – for better or for worse – on the basis of whether the proposed pledge of utility assets at issue in this proceeding is approved or not. *Tr. 74*. Mr. Mann agreed with this assessment. *Tr. 106-107*. Not only would the pledge of Iowa utility assets have no effect on the Iowa customers' ability to obtain their deposits (as discussed above), the general impact of a bankruptcy on those customers would not significantly vary on the basis of whether the secured lenders did or did not have a pledge of the Iowa utility assets. *Tr. 90*. The primary reason this is so is that in most Chapter 11 bankruptcies the debtor must obtain debtor-in-possession (DIP) financing. *Tr. 90*. The DIP lenders that provide that financing to the debtor are almost invariably granted a lien on all debtor assets that have not previously been pledged. *Tr. 90, 96-97*. As a

result, even if a pledge of Iowa assets did not occur before a bankruptcy filing, those assets would, in all likelihood, be pledged to the DIP lenders following the filing. *Tr. 90*. As Mr. Mann summed it up during direct examination at the hearing:

But from the customers' point of view, whether those assets were pledged three years ago and are, therefore, not available to them or are pledged the day after bankruptcy, they're still not available to those customers, so from the customers' point of view, I don't think it makes any difference at all.

*Tr. 105*.

**2. The public interest will not be detrimentally affected by the proposed pledge of Iowa utility assets.**

There is absolutely nothing in the evidentiary record showing or purporting to show that the proposed pledge of Iowa utility assets will have any adverse effect on the interest of the public at large considered as separate and distinct from Aquila's ratepayers. On the contrary, the evidence shows at least the potential for the public interest to be detrimentally affected.

According to Aquila's bankruptcy expert, denial of Aquila's application in this proceeding by itself would not cause Aquila to file for bankruptcy. *Exh. 202, Sched. A, p. A-113*. He observed, however, that denial could cause Aquila's restructuring to be more expensive, which would affect the chances for a successful restructuring outside of bankruptcy. *Exh. 202, Sched. A, p. A-113*. He further observed that bankruptcy is "generally not good news for any constituent party to a bankruptcy proceeding" and that "a bankruptcy of Aquila, at any time, is not in the best interests of Aquila's constituent parties." *Tr. 89-90*. The interests of secured creditors, unsecured creditors employees, and shareholders are all at greater risk in a bankruptcy than in a fully consensual financial restructuring. *Tr. 89*. OCA witness Vitale agrees with

Aquila's bankruptcy expert that in many bankruptcies the interests of shareholders, large and small, are totally eliminated. *Tr. 89, 281-282.* All stakeholders – not just shareholders – are adversely affected by bankruptcy. *Tr. 107.*

**3. The ability of Aquila to provide safe, reasonable, and adequate service will not be impaired by the proposed pledge of Iowa utility assets.**

A key goal and guiding principle of Aquila's debt reduction and financial restructuring plan is the maintenance of high-quality customer service. *Tr. 12.* The plan utilizes three primary means to secure this goal: (i) continuing appropriate funding of capital expenditures; (ii) ensuring adequate customer service staffing; and (iii) establishing and monitoring internal customer service performance metrics and measures. *Tr. 12, 15.* Each state operating vice president is required to prepare and submit monthly written status reports, and detailed quarterly reviews of service quality performance for each state are conducted with Aquila's chief operating officer. *Tr. 15.*

Aquila's operating vice president for Iowa – Ivan Vancas – appeared as a witness in this proceeding and testified specifically about service quality matters. As he explained, this year Aquila adopted a survey approach to measuring customer satisfaction with respect to four measures: connection of service, payment arrangements, billing, and image. *Tr. 239.* This new approach was taken in order to secure more meaningful data for evaluating Aquila's performance. *Tr. 240.* The most recent customer satisfaction survey results available (June 2003) demonstrate that Aquila's performance with respect to each of the four measures would, according to the Gallup organization, be classified as "strong." *Tr. 240.* With respect to service

quality measures such as connecting new service, responding to complaints, billing accuracy, and emergency service, Aquila has maintained or improved its performance over the past year. *Tr.* 242-246.

Aquila spent approximately \$5.2 million on maintenance, repair, and capital investment in 2002 and expects to spend the same amount this year.<sup>14</sup> *Tr.* 256-257. In fact, in 2002 Mr. Vancas exceeded his budget – which was put together prior to his assuming his present position as operating vice-president responsible for Iowa – by about \$1 million. *Tr.* 257. He believed the budgeted amount was insufficient, and sought and was provided with the additional \$1 million. *Tr.* 257. Aquila’s capital spending during the past eighteen months has actually exceeded historical levels. *Tr.* 257. Aquila has provided its Iowa operation with adequate funding, both from a capital and “O&M” perspective, to provide safe and reliable service, and will continue to fund its Iowa operations at consistent levels. *Tr.* 248, 256-257. When OCA witness Vitale was asked by a Board member to voice his opinion on Aquila’s assurance that adequate service-quality investment in Iowa will continue, Mr. Vitale did not disagree. *Tr.* 364.

According to Mr. Vancas, the OCA has not expressed any concerns about Aquila’s current level of service quality to him or, to the best of his knowledge, to anyone else at Aquila. *Tr.* 240. This testimony is consistent with the limited record the OCA made on service quality issues in this proceeding. When asked by the Board whether the OCA has any *specific* concerns with respect to Aquila’s current service quality, OCA witness Vitale was unable to identify a single specific service quality problem. *Tr.* 298-A. Mr. Vitale claimed to be concerned about a past focus on acquisitions and unregulated operations that purportedly distracted management

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<sup>14</sup> Approximately \$3 million was for maintenance alone. *Tr.* 257.

from it regulated utility operations, but did not identify a single specific example of service quality degradation resulting therefrom. *Tr. 298-A*. Mr. Vitale also claimed to have a concern about a reduction of 550 staff in Aquila's regulated utility operations, but again failed to go the further step of identifying even one instance where such staff cuts adversely affected Aquila's service quality. *Tr. 298-A*. Moreover, as Mr. Vancas testified, only five of Aquila's employees involved in workforce reductions were based in Iowa, and none was a customer service associate. *Tr. 240-241, 236, 248-249*. In addition, these staff reductions were implemented in 2002, not as part of the debt reduction and corporate restructuring activities that followed, but as part of a prior program to transition Aquila to a state-based management structure. *Tr. 241*. In sum, Mr. Vitale's purported concerns about Aquila's current service quality turn out to be nothing more than mere speculation, lacking any support in actual fact.

**4. Aquila's ability to attract capital on reasonable terms, including the maintenance of a reasonable capital structure, will not be impaired by the proposed pledge of Iowa utility assets.**

As discussed at length in section II.A.1. above, Aquila has made a commitment to maintain its capital allocation process, which utilizes hypothetical capital structures and long-term debt assignments. Aquila intends to maintain this capital allocation process, including the comparable company debt/equity ratios and the current long-term debt assignment process, during the tenure of its debt reduction and restructuring plan (which encompasses the full term of the three-year term loan). *Tr. 15*. The proposed pledge of Iowa utility assets for which Aquila is seeking Board approval helps provide the working capital Aquila needs to execute the plan and fulfill its commitment to maintain the capital allocation process. Consequently, the proposed

pledge will actually benefit, not impair, Aquila's ability to attract capital on reasonable terms and maintain a reasonable capital structure.

OCA witness Vitale argued at the hearing that if the Iowa utility assets are pledged Aquila may not be able to go to capital markets to meet additional liquidity needs. *Tr. 357-360*. In his direct oral testimony Empson exposed the fallacy behind Mr. Vitale's argument. *Tr. 51-54*. As Mr. Empson explained it, all pledged assets in excess of 1.67 times the loan balance at that time would be available to Aquila to support any additional capital needed. *Tr. 51-53*. In fact, any pledged assets in excess of that amount could be sold and used in any manner Aquila desired. *Tr. 53-54*. In addition, pledged assets within that amount could be sold and used as Aquila chose to the extent that the outstanding loan balance was reduced by the proceeds of such sale to less than or equal to 1.67 times the residual loan balance. *Tr. 54*.

**5. The Board will continue to have reasonable access to the books, records, documents and other information relating to Aquila.**

The proposed pledge of Iowa utility assets will have absolutely no detrimental effect on the Board's current access to the books, records, documents, and other information relating to Aquila. The pledge itself is absolutely neutral with respect to the quality or degree of such access, as shown by the total absence of any evidence in the record showing anything to the contrary.

However, it must be borne in mind that the pledge is only one component of Aquila's overall debt reduction and financial restructuring plan (as explained above in this brief), and that one of the major purposes of the plan as a whole is to improve the Board's access to the books,



records, documents, and other pertinent information about Aquila and its operations in Iowa. In fact, one of the three key goals and guiding principles of Aquila's plan is the enhancement of regulatory transparency. *Tr. 12.*

Immediately prior to implementation of the first phase of the plan, but consistent with the plan's guiding principle of refocusing Aquila's operations on the domestic network business, Aquila made a successful transition to a state-based organization. *Tr. 12, 241.* Aquila implemented a state-based utility organization focused on providing first-rate service to its customers and taking advantage of the common accounting and billing systems, common executive management, and standardized operational practices Aquila developed during the mid-1990s. *Tr. 16.* Aquila's goal is to achieve a more transparent utility structure by creating an operational focus in Iowa and reducing costs allocated to Iowa. *Tr. 16.* This transparent, state-based structure should facilitate the Board's understanding and review of Aquila's Iowa operations. *Tr. 16.*

A second important component to Aquila's continuing commitment to the enhancement of regulatory transparency is Aquila's corporate cost allocation manual. *Tr. 12.* Aquila maintains a detailed cost allocation manual that is revised as necessary and at least annually. *Tr. 16.* The manual was audited by an independent auditor as recently as 2002. *Tr. 16.* As the independent auditor observed in the audit, "appropriate cost allocation is high on [Aquila's] list of priorities." *Tr. 16.*

Similarly, Aquila is committed to adhering to a detailed affiliate transactions policy and procedures manual first developed in 2002. *Tr. 12.* This commitment is part of Aquila's larger commitment to ensure that asset sales and the provision of services between utility and non-

utility affiliates are priced appropriately. *Tr. 16.*

Aquila has also developed a code of business conduct that provides employees with guidelines designed to assist them in understanding their ethical responsibilities. *Tr. 17.* All employees have easy access to this code, and training in the key elements of the code is mandatory for all current and new employees. *Tr. 17.*

**B. The Board should reject the OCA's suggestion that Aquila be required to establish a holding-company structure as a condition of the Board's approval of Aquila's proposal to pledge its Iowa utility assets.**

OCA witness Vitale recommended in his prepared written testimony that Aquila be required to establish a holding company-structure as a condition of the Board's approval of Aquila's proposal to pledge its Iowa utility assets. *Tr. 284, 315-316.* He held Portland General up as a prime example of how a holding-company structure insulates a utility's customers from the risks associated with unregulated operations. *Tr. 276, 287-288, 296-297.* As Mr. Vitale explained it, the advantage of the holding-company structure is "reflected" by the fact that, even though Portland General is a utility subsidiary of Enron and Enron has filed for bankruptcy due to its unregulated activities, Portland General has not filed for bankruptcy and continues to have an investment-grade credit rating from Moody's and Standard & Poor's. *Tr. 287, 297.*

Mr. Vitale acknowledged that the Board already has at least one regulatory mechanism available (the rate case) to protect Aquila's Iowa utility customers in the ordinary course of business, but claimed that this mechanism is not available in the event of an Aquila bankruptcy. *Tr. 274-275.* He then proceeded to argue that the establishment of a holding-company structure for Aquila is necessary to protect Iowa utility assets from the risk of following Aquila into

bankruptcy. *Tr. 288, 297.*

What Mr. Vitale completely overlooked when he made his holding-company recommendation in his written testimony is that the three-year term loan agreement prohibits Aquila from establishing a holding-company structure and transferring utility assets to a subsidiary. *Tr. 77; Exh. 201, Sched. A, p. 64, art. 5.12.* Moreover, Mr. Vitale's commitment to his recommendation wavered significantly under intense questioning by the Board. When asked whether the establishment of a holding-company structure would "do any good at this point, given the position the company is in," Mr. Vitale replied: "I have never advocated doing that at this point in time." *Tr. 365.* He went on to admit that he was "very cognizant of the limitations in the loan agreement about setting up separate subsidiaries or holding companies, so I've never advocated . . . ." <sup>15</sup> *Tr. 365.* The Board member who asked the question obviously interpreted his answer to mean that the OCA is not really advocating a holding-company structure and said as much, to which the witness somewhat feebly replied: "I think that's something we should move towards is a holding company structure." *Tr. 366.*

No matter what position the OCA ultimately decides to take on this issue, however, it is undeniable that the evidentiary record conclusively establishes that imposing such a requirement on Aquila as a condition of the Board's approval of Aquila's proposed pledge of Iowa utility assets would not protect Iowa utility assets from inclusion in any Aquila bankruptcy. In addition, the record shows that OCA's reliance on the Portland General example is misplaced.

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<sup>15</sup> Unfortunately, Mr. Vitale went off on a tangent at this point and never told us what he had never advocated. *Tr. 365.* From the context and his previous testimony, however, it appears that what he had never advocated – or at the very least should never have advocated – was requiring Aquila to establish a holding-company structure during the term of the three-year term loan agreement because covenants in the loan agreement prohibit such action.

According to the ring-fencing paper prepared by the NARUC Subcommittee on Accounting and Finance, one credit rating agency (Fitch) recently told an assembly of several state regulatory staff members that “companies have an inalienable right to file a subsidiary into bankruptcy” and that this right cannot be waived. *Exh. 109, p. 10*. In fact, as the only bankruptcy law expert appearing in this proceeding – Aquila witness Mann – testified, in large corporate bankruptcy proceedings the parent files not only for itself for also for most, if not all, of its operating subsidiaries and obtains what is called “joint administration” of all the filings in a single unified proceeding. *Tr. 88*. He further testified that even if Aquila were to create separate corporations for each of its domestic utility business, all of them owned by a single holding company, Aquila could not effectively insulate the utility subsidiaries from the current obligations of Aquila. *Tr. 92*.

Aquila cannot simply cannot leave any non-utility obligations in a holding company and transfer all of the utility assets to newly created utility subsidiaries free and clear of those obligations. *Tr. 92*. Current creditors of Aquila would have a continuing claim to those utility assets. *Tr. 92-93*. Aquila already has debt obligations, and even if a new subsidiary were created today, the subsidiary would not be free of the obligations Aquila already has.<sup>16</sup> *Tr. 121*.

In fact, if Aquila were to attempt to create utility subsidiaries and transfer all of the utility assets to them, it is highly likely that existing creditors would force Aquila into bankruptcy immediately. *Tr. 93*. Moreover, creditors who are providing funds or credit to Aquila generally for operation of its various utility business would be unlikely to continue to extend credit to a

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<sup>16</sup> As Mr. Mann summed up the situation in colloquial terms: “I think the horse is already out of the corral. It’s a little late to shut the gate, to be effective by doing so.” *Tr. 121*.

corporate holding company that has no operating assets, and would likely require all of the utility subsidiaries to be jointly obligated on the debt. *Tr. 93.*

For all of these reasons, Mr. Mann concluded that the avoidance of bankruptcy proceedings altogether – which is what Aquila is working toward with its debt reduction and financial restructuring plan – rather than the creation of separate legal entities is the best way to keep Aquila’s Iowa utility business out of the entanglement of a bankruptcy proceeding.<sup>17</sup> *Tr. 88.*

Aquila witness Empson concurred with Mr. Mann’s assessment:

Q. Mr. Empson, do you believe that the establishment of a holding company structure now would suffice to protect Aquila’s regulated operations from bankruptcy?

A. I do not.

Q. And would you explain why.

A. At this point in time, given the structure that Aquila has been operating under, we have all of our utilities set up as divisions, and then we have wholly-owned subsidiaries as part of Aquila. So the unsecured debt that we have at this time is based upon all the assets of Aquila, Inc., so it would be virtually impossible, as testified by Mr. Mann, who will be up on the witness stand a little later, to try to isolate any debt at this point in time and assign it to the utility property. *So we cannot really shelter, at this point in time, anyway, through a holding company structure, the utility operations. The shelter we are providing is through the regulatory plan that we have proposed in this proceeding.*

*Tr. 48-49 (emphasis added).*

Mr. Vitale’s fundamental reliance on the Portland General in this case is so mistaken as to be puzzling. A brief tour of the highlights of Portland General’s Form 10-Q dated March 31,

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<sup>17</sup> See also the discussion of the doctrine of substantive consolidation at pages 6-7 of the continuing legal education presentation dated February 13, 2003, that appears in Exh. 121.

2003, demonstrates how far off the mark the OCA is in its understanding and portrayal of the Portland General situation. The fact of the matter is that as a result of the bankruptcy of its Enron parent, Portland General has experienced credit downgrades, is vulnerable to future changes in credit ratings, and has difficulty accessing commercial paper markets. *Exhs. 102, 103.*

Portland General has been the subject of credit downgrade concerns since the time Enron declared bankruptcy: Moody's and Standard & Poor's have lowered Portland General's credit rating for unsecured debt, and Fitch has currently assigned it a below-investment-grade rating. *Tr. 19.* Portland General does not have the ability to access the commercial paper market due to the May 2002 ratings reductions for commercial paper by Moody's and Fitch. *Tr. 19.* Portland General has significant financial exposure relating to the Enron bankruptcy. *Tr. 20.* Portland General's own management states that it "cannot predict with certainty what impact Enron's bankruptcy may have" on it and that it "may have potential exposure to certain liabilities and asset impairment as a result of Enron's bankruptcy." *Tr. 20.*

In point of fact, Portland General operates much as Aquila did, with an embedded subsidiary energy commodity trading business. *Tr. 20.* In other words, Portland General's regulated and nonregulated businesses are, as Mr. Vitale would characterize it, "commingled" within the utility business. *Tr. 20.* Portland General participates in electricity, natural gas, and crude oil commodity markets by use of electricity forward and option contracts, natural gas forward, swap, and futures contracts, and crude oil futures contracts. *Tr. 20.*

In sum, the Board should reject the OCA's apparent (and possibly now abandoned) recommendation that Aquila be required to establish a holding-company structure as a condition

of the Board's approval of Aquila's proposal to pledge its Iowa utility assets to support the three-year term loan.

### III. CONCLUSION

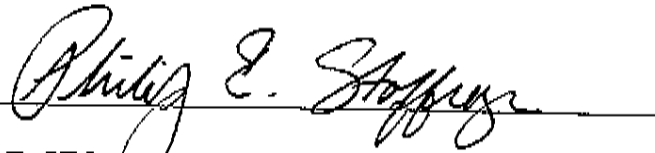
Aquila has carried its statutory burden of establishing that the proposed pledge of its Iowa utility assets as collateral to support the three-year term loan is not contrary to the interests of Aquila's ratepayers or to the public interest. Accordingly, Aquila respectfully requests the Board to issue an order declining to disapprove Aquila's proposed and terminating this docket. Aquila also asks the Board to find and determine that such pledge may extend to any future extension or rollover of the three-year term loan and future replacement debt offering for the working capital requirements of Aquila's domestic utility operations.

Dated September 12, 2003.

Respectfully submitted,

AQUILA, INC. d/b/a AQUILA NETWORKS

By \_\_\_\_\_



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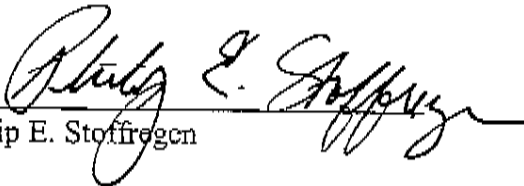
ITS ATTORNEY

**CERTIFICATE OF SERVICE**

I hereby certify that I have this day served the foregoing document on the following persons and parties as required by the rules of the Iowa Utilities Board:

John F. Dwyer (3 copies)  
Office of Consumer Advocate  
Consumer Advocate Division  
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