

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of the Application of)
Southern Missouri Gas Company, L.P.)
d/b/a Southern Missouri Natural Gas)
for a certificate of public convenience)
and necessity authorizing it to)
construct, install, own, operate,)
control, manage and maintain a)
natural gas distribution system to)
provide gas service in Lebanon,)
Missouri.)

Case No. GA-2007-0212 et al.

STAFF'S BRIEF

COMES NOW the Staff of the Commission and for its Brief in this matter states:

INTRODUCTION

Southern Missouri Natural Gas (SMNG or Company) has applied for a Certificate of Convenience and Necessity (CCN) to serve Lebanon, Houston and Licking Missouri.¹ Staff recommends the application be approved with the condition that the Company submit financing arrangements acceptable to Staff and the Commission.²

Southern Missouri Natural Gas Company, L.P., doing business as Southern Missouri Natural Gas ("SMNG"), is a Missouri limited partnership with its principal place of business at 301 East 17th Street, Mountain Grove, Missouri. SMNG owns and operates a natural gas transmission and distribution system in southern Missouri serving approximately 7,500 residential, commercial and industrial customers.³ SMNG

¹ Tr. Vol. 2, pp. 31-32.

² Tr. Vol. 2, p. 251, ls. 12-15.

³ Tr. Vol. 2, p. 70, ls. 16-17.

currently serves the communities of Rogersville, Marshfield, Ava, Norwood, Mountain Grove, West Plains, Willow Springs, Cabool, and Mansfield in six Missouri counties.⁴

PROCEDURAL HISTORY

On December 6, 2006, Southern Missouri Gas Company, L.P. d/b/a Southern Missouri Natural Gas (SMNG or Company), of Mountain Grove, Missouri, filed for a certificate of public convenience and necessity (CCN) authorizing it to construct, install, own, operate, control, manage, and maintain a natural gas system to provide gas service in Lebanon, Missouri (Application).⁵

On December 12, 2006, SMNG filed a financing application for expansion into Lebanon, Mountain View, Houston, and Licking, Missouri.⁶ The Company is no longer seeking authorization to expand into Mountain View.⁷ On January 25, 2007, the Commission issued an order granting intervention to the Missouri Propane Gas Association and directing the Staff to file a recommendation or status report no later than February 27, 2007.⁸

On February 15, 2007, SMNG filed an application for a CCN to serve Houston, Licking, and Mountain View, Missouri.⁹ Also on February 15, 2007, the Company filed a motion to consolidate the three cases. On March 8, 2007, the Commission issued an order consolidating the three cases with GA-2007-0212 designated the lead case.¹⁰

⁴ Tr. Vol. 2, p. 73, ls. 21-23.

⁵ Exh. 19, Staff Memorandum, p. 1.

⁶ Exh. 19, Staff Memorandum, p. 1.

⁷ Tr. Vol. 2., p. 31, ls. 10-14.

⁸ Exh. 19, Staff Memo., p. 1.

⁹ Exh. 19, Staff Memo., p.2.

¹⁰ *Id.* at p. 3.

On April 3, 2007, the Commission issued an order granting intervention to Southern Star Central Gas Pipeline, and on April 18, 2007, the Commission ordered Staff to file a recommendation or status report no later than May 15, 2007. On May 16, 2007, the Missouri Propane Gas Association filed a Motion to Dismiss or in the Alternative Stay Proceedings. The Commission denied MPGA'S Motion.

Ownership Information

SMNG is owned by three equity investors through Sendero SMGC GP Acquisition Company, LLC (Sendero GP), and Sendero SMGC Limited Acquisition Company, LLC (Sendero LP). SMNG is the only investment held by Sendero GP and Sendero LP. The equity interests in Sendero GP and Sendero LP are divided into three different classes. CHx Capital Missouri, Inc. (CHx Missouri) owns 100% of the Class A Interest in each company, which comprises 95% or \$2,850,000 of initial equity capital contributed to the investment. Sendero Capital Partners Missouri, as Missouri Limited Liability Company (SCPM) owns 100% of the Class B Interest, which comprises 3.33% or \$100,000 of initial equity capital contributed to the investment. Michael Lewis, an individual residing in the state of Texas, owns 100% of the Class C Interest, which comprises 1.67% or \$50,000 of initial equity capital contributed to the investment. CHx Missouri holds three of the four board seats governing Sendero GP and Sendero LP, and SCPM holds the remaining board seat. Mr. Maffett is currently seeking to recapitalize SMNG.

Discussion

In CCN cases, the Commission is charged with considering what is in the interest of the public; specifically what is "necessary or convenient for the public service." "The

PSC has authority to grant certificates of convenience and necessity when it is determined after due hearing that construction is “necessary or convenient for the public service.” § 393.170.3. The term “necessity” does not mean “essential” or “absolutely indispensable,” but that an additional service would be an improvement justifying its cost.”¹¹

What is Necessary and Convenient for the Public Service?

The Court of Appeals has noted that the Legislature has not set out a formula for determining when a Certificate of Convenience and Necessity (CCN) should be granted:

“[f]or some reason, either intentional or otherwise, the General Assembly has not seen fit to statutorily spell out any specific criteria to aid in the determination of what is ‘necessary or convenient for the public service’ within the meaning of such language as employed in Section 393.170 . . .”¹²

The same Court found that the safety and adequacy of facilities are criteria that may be considered, but that they are not the only criteria. The Court of Appeals has also stated that “the term ‘necessity’ does not mean ‘essential’ or ‘absolutely indispensable’, but that an additional service would be an improvement justifying its cost.”¹³

The dominant purpose in creation of the Commission is public welfare. The administration of its authority should be directed to that purpose. In every case where it is called upon to grant a permit, or to authorize an additional service to be rendered by an authorized certificate holder, the Commission should be guided, primarily, by considerations of public interest.¹⁴

¹¹ *Intercon Gas, Inc., v. Public Service Comm’n*, 848 S.W.2d 593, 597 (Mo.App.1993) citing *State ex rel. Beaufort Transfer Co. v. Clark*, 504 S.W.2d 216, 217 (Mo.App.1973).

¹² *State ex rel. Ozark Elec. Co-op. v. Public Service Commission*, 527 S.W.2d 390, 394 (Mo. App. S.D. 1975).

¹³ *State ex rel. Intercon Gas, Inc., v. Public Service Commission*, 848 S.W.2d 593, 597 (Mo. App. 1993), citing *State ex rel. Beaufort Transfer Co. v. Clark*, 504 S.W.2d at 219.

¹⁴ *Missouri Pacific Freight Transport Co. v. Public Service Commission*, 288 S.W.2d 679, 682 (Mo. App. 1956).

The Courts have indicated that there is not a single factor. [T]he determination of public interest is a balancing test between public and private interests.¹⁵ And further, “[n]o *one* factor is dispositive in balancing public versus private interests. Each case stands on its own facts and circumstances.”¹⁶ In summary, the Commission should balance all relevant factors, both the benefits and detriments, to determine whether a particular proposal is in the interest of the public as a whole. Staff recommends that the proposal is reasonable, the project is in the public interest and the CCNs should be approved so long as acceptable financing arrangements are made.¹⁷

Feasibility Study

Staff’s analysis of the feasibility of the system included evaluation of the inputs to the feasibility study, estimated household data based upon federal census data, conversion to natural gas of various types of existing customers, various costs associated with providing service to existing and new areas, proposed capital expenditures, and other assumptions.¹⁸

In addition to its review of the inputs, the Staff analyzed the effects of various changes to the assumptions, substituting more conservative estimates in place of some of the Company’s inputs.¹⁹ None of these changes changed Staff’s recommendation that the Company’s application be granted.

The feasibility of these projects was evaluated by looking at the internal rate of return (IRR) for the project over the twenty (20) years covered by the model plus a

¹⁵ *Rhein v. City of Frontenac*, 809 S.W.2d 107 (Mo. App. 1991). See also, *Hoffman v. City of Town and Country*, 831 S.W.2d 223 (Mo. App. E.D. 1992), and *Huttig v. City of Richmond Heights*, 372 S.W.2d 833 (Mo. 1963).

¹⁶ *Id.* at 110.

¹⁷ Tr. Vol. 2, p. 251, ls. 12-15.

¹⁸ Exh. 19, Staff Memo. p. 2.

¹⁹ *Id.*

terminal value.²⁰ A hurdle rate of ten percent (10%) was considered to be the break point for feasibility. The IRR produced in the model, as adjusted by Staff, is thirteen percent (13%). The model, as submitted, produces an IRR of forty-one percent (41%) by this calculation.²¹

Staff's conclusion is that even with the more conservative inputs Staff used in the Company's model, the expansion project should be feasible, though certainly not without risk.²² The first of those risks is that the Company's conversion rate will be affected by embedded, entrenched competition from propane dealers, whose prices and business practices are unregulated.²³

Besides the competition from propane, there is language in each of the franchise agreements that gives each respective city the option to purchase the distribution system within it for the net book value plus 15%. If any of the cities exercises this option, it would place the Company in violation of the order in Commission Case No. GA-94-127, in which the Commission noted "that Tartan [the predecessor of Southern Missouri Gas and of Southern Missouri Natural Gas] provide only retail natural gas service to the ten municipalities from which it has received franchises . . ." [Commission Report and Order, Case No. GA-94-127, p. 9].²⁴

The obligation to serve

Missouri case law indicates that when the Commission grants a Certificate of Convenience and Necessity it is a mandate for a utility to serve customers in the

²⁰ Exh. 19, Staff Memo. p. 3.

²¹ *Id.*

²² Exh. 19, Staff Memo. p. 3.

²³ Tr. Vol.2, p. 248 ls. 5-13.

²⁴ Tr. Vol. 2, p. 248, ls. 15 21.

certificated area and it is the utility's duty, **within reasonable limitations**, to serve all persons in an area it has undertaken to serve.

“The corporate charter is a contract which impliedly obligates the corporation to furnish the service for which it was created to render. Section 393.130 specifically requires that ‘every gas corporation * * * shall furnish and provide such service instrumentalities . . . as shall be . . . adequate. . . . [I]t is the utility's duty, **within reasonable limitations**, to serve all persons in an area it has undertaken to serve.’²⁵

The Company's Commission-approved tariffs, like those of most Missouri LDC's, Tr. Vol. 1, p. 305, ls. 17-18) contain four provisions defining when it may reasonably decline to provide service. First, the Company provides the first 125 feet to serve an individual customer, but if line to serve the customer must extend beyond that, the customer pays for the additional line.²⁶ The second situation involves the laying of a main to a remote customer. If the distance is in excess of 120 feet, the customer is expected to pay for the additional main at the cost of \$12.50 per foot.²⁷ The third situation is that of a subdivision in which the developer builds the system and as customers come on the system, the developer is reimbursed for the cost of the system.²⁸ There is a fourth provision in the Company's tariffs at page 68 which provides: “whenever there is insufficient gas available to serve an applicant for gas service. . . .”

²⁵ *State ex rel. Ozark Power & Water Co. v. Public Service Commission*, 287 Mo. 522, 229 S.W. 782; *State ex rel. Kansas City Power & Light Co. v. Public Service Comm'n*, 335 Mo. 1248, 76 S.W.2d 343; *State ex rel. Federal Reserve Bank of Kansas City v. Public Service Commission*, 239 Mo.App. 531, 191 S.W.2d 307; and *May Department Stores Co. v. Union Electric Light & Power Co.*, 341 Mo. 299, 107 S.W.2d 41.

²⁶ Tr. Vol. 2, p. 305, ln. 16 – p. 306, ln. 16.

²⁷ Tr. Vol. 2, p. 306, ls. 17-21.

²⁸ Tr. Vol. 2, p. 306, ln. 22 – p. 307, ln. 13.

In sum, the company has an obligation to serve “anyone in their service area but not at any cost.”²⁹

Financing Recommendation

SMNG seeks authority to issue approximately \$10 million in additional equity capital and approximately \$50 million in notes and other forms of indebtedness (“debt securities”) with maturities of up to 10 years. The interest rate to be paid on the debt securities will be based on a market-based spread to LIBOR.³⁰ Staff is not concerned that this financing will effect current customers of the company, except for the possibility of bankruptcy, because the Commission would have to approve any rate increase.³¹ Staff intends to do a thorough review of the financing details once Staff receives the information.³²

Staff does not presently recommend approval of SMNG’s financing application because the final terms and conditions are as yet unknown.³³ SMNG has informed Staff that the equity investors will be one or two large, accredited, institutional investors with specific industry knowledge and experience relevant to the proposed investment and financing of SMNG as well as projected ranges of terms and conditions it expects to transact.³⁴ SMNG is currently still engaged in negotiations with potential investors and, once its negotiations are complete, will file an amendment to its Application with supporting documentation. After SMNG has filed this information, Staff will issue its final recommendation on SMNG’s financing application.

²⁹ Tr. Vol. 2, p. 307, ls. 21-22.

³⁰ Tr. Vol. 2, p. 283, ls. 3-21.

³¹ Tr. Vol. 2, p. 283, ln. 22 - p. 285.

³² Tr. Vol. 1, p. 292, ls. 19-21.

³³ Exh. 19, Staff memo. P. 3.

³⁴ *Id.*

While Staff believes the ultimate investors (both equity and debt investors) will be sophisticated enough to base their assessment of the risk associated with this investment on the risk of the potential cash flows associated with SMNG and its expansion proposal, it is prudent for the Commission to condition its grant of a CCN on receipt of the terms and conditions proposed by the ultimate investors to evaluate the financing terms.³⁵

Staff has concerns, which it will pursue separately, about the Company's current audited financial statements, and the accounting for a write-down of the assets.³⁶ Staff's concern is that investors not be mislead as to the value of the properties.³⁷ SMNG testified the equity investor(s) will be one or two large accredited institutional investors with specific industry knowledge and experience relevant to the proposed investment and financing of SMNG as well as projected ranges of terms and conditions it expects to transact. Staff has concerns about the Company's current audited financial statements, and the accounting for a write-down of the assets, which it will pursue separately.³⁸

Staff's position is the Commission may reasonably issue a conditional CCN with the condition that applicants submit a financing proposal acceptable to Staff and the Commission. Additionally, approval of the application for CCN should be conditioned on the shareholders bearing the risk of failure. Further, the Commission should order that, if any of the cities served by the Company exercise the option to purchase its distribution system, the Company must apply to the Commission for a waiver from the

³⁵ Tr. Vol. 2, p. 272, ls. 6-13.

³⁶ Tr. Vol. 2, p. 278, ls. 3-7.

³⁷ Tr. Vol. 2, p. 281 ln. 14- p. 282, ln. 4.

³⁸ Tr. Vol. 2, p. 66, ls. 12-25.

Commission order in Case No. GA-94-127, in which the Commission noted “that Tartan [the predecessor of Southern Missouri Gas and of Southern Missouri Natural Gas] provide only retail natural gas service to the ten municipalities from which it has received franchises . . .”

WHEREFORE the Commission should issue a conditional CCN with the condition that applicants submit a financing proposal acceptable to Staff and the Commission, that the shareholders bear the risk of failure and, that, if any of the cities served by the Company exercise the option to purchase its distribution system, the Company must apply to the Commission for a waiver from the Commission order in Case No. GA-94-127, in which the Commission noted “that Tartan [the predecessor of Southern Missouri Gas and of Southern Missouri Natural Gas] provide only retail natural gas service to the ten municipalities from which it has received franchises . . .”

Respectfully submitted,

/s/ Lera L. Shemwell _____
Lera L. Shemwell
Deputy General Counsel
Missouri Bar No. 43792

Attorney for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 751-7431 (Telephone)
(573) 751-9285 (Fax)
E-mail: lera.shemwell@psc.mo.gov

Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or electronic mail to all counsel of record this 13th day of August 2007.

/s/ Lera Shemwell