Staff Exhibit No. 19
Date 7-27-07 Case No. GA-2007-0212
GA-2007-0316
GF-2007-0215
Reporter JMB

MEMORANDUM

TO: Missouri Public Service Commission Official Case File, Case No. GA-2007-0212, *et al.*, Southern Missouri Gas Company, L.P. d/b/a Southern Missouri Natural Gas

FROM: David Murray, Financial Analysis Department
Tom Solt, Energy Department – Tariffs/Rate Design

/s/ Thomas A. Solt 06/13/07
Case Coordinator/ Date

/s/ Lera Shemwell 06/13/07
Office of General Counsel/ Date

SUBJECT: Staff Recommendation to Conditionally Approve Southern Missouri Natural Gas' Application to Expand Service into Lebanon, Houston, and Licking and to Withhold Approval of the Financing Application

DATE: June 12, 2007

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). On December 12, 2006, SMNG filed a financing application for expansion into Lebanon, Mountain View, Houston, and Licking, Missouri. On December 21, 2006, the Commission ordered Staff of the Missouri Public Service Commission (Staff) to file a recommendation or status report no later than January 22, 2007. 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. On February 15, 2007, SMNG filed an application for a CCN to serve Houston, Licking, and Mountain View, Missouri. Also on February 15, 2007, the Company filed a motion to consolidate the three cases. On March 5, 2007, the Commission issued an order directing Staff to file a recommendation or status report no later than April 15, 2007. On March 8, 2007, the Commission issued an order consolidating the three cases with GA-2007-0212 designated the lead case. 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 15, 2007, Staff filed its response to that order. On May 16, 2007, the Missouri Propane Gas Association filed a Motion to Dismiss or in the Alternative Stay Proceedings. On May 22, 2007, Staff provided the Company with a draft of its recommendation. On May 25, 2007, Staff filed its Notice of Receipt of the Company's response. On June 7, 2007, Staff filed a status report.

Background 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). These equity investors executed a Limited Liability Company Operating Agreement (LLC

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Appendix A

Agreement) on March 23, 2005, to provide terms and conditions for the ownership and operations of SMNG. In conjunction with the LLC Agreement, the equity investors also entered into a Members' Agreement as of the same date. The Members' Agreement governs the rights and obligations of the equity investors with respect to their equity interests in Sendero GP and Sendero LP. It is Staff's understanding the only investment held by Sendero GP and Sendero LP is that of SMNG. However, the equity investors in Sendero GP and Sendero LP have investments in other enterprises through other affiliates. 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.

CHx Missouri appears to be a wholly-owned subsidiary of CHx Capital, LLC (CHx Capital), which is a wholly-owned subsidiary of Aspect Energy, LLC (Aspect). CHx Capital is a private investment firm of the Cranberg/Morrice family, which was founded in 2001 and is based in Denver, CO. CHx Capital maintains a diversified portfolio in energy (gas distribution, oil and gas exploration) and diversified investments (aviation, real estate). Aspect Energy is a privately owned independent oil and gas exploration and energy investment company. An affiliate of SCPM, Sendero Asset Management, LLC, was established for the purpose of providing asset management services to companies it acquires. Sendero Asset Management, LLC is wholly owned by Sendero Capital Partners, Inc.

Certificate Recommendation

The Staff issued a number of Data Requests (DRs) addressing both the feasibility study and the financing request, reviewed the various applications, feasibility studies, materials submitted by SMNG, and DR responses. Inputs to the feasibility study include 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.

Staff analyzed the effects of various changes to the assumptions, substituting more conservative estimates in place of some of the Company's inputs. Staff made the following adjustments to the Company's model: growth rates were replaced by the Company's actual growth experienced on the existing system from 1995 to 2000, removed all gas sales revenue and expense, added inflation during 2007 for the current SMNG system, tripled the distribution cost per customer from $500 to $1,500, added an allowance for interest on working capital, and doubled the estimated pipeline cost from $9,750,000 to $19,500,000.

The feasibility 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 terminal value. 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.

The Company's model represents that, even with more conservative inputs in place, the expansion project should be feasible, though certainly not without risk. Staff has no personnel with gas pipeline construction or distribution system construction experience, and relies on the representations made by the Company and in its model that, with the given inputs to the Company's model, and if the assumptions used therein are realized, the expansion would be feasible.

The Commission should be aware of two feasibility issues. First, the Company will face embedded, entrenched competition from propane dealers, whose prices and business practices are unregulated. Using information from the Energy Information Administration, the residential price per gallon of propane on March 12, 2007, was $1.68, which equates to an equivalent price per Ccf of natural gas of $1.83. SMNG's PGA rate for natural gas in March was $0.95 per Ccf. Since the price of propane is a delivered price, I calculated the delivered price of 1,000 Ccf of natural gas to compare with the equivalent of 1,000 Ccf of propane, by adding to the price per Ccf of natural gas, the commodity charge of $0.357 and the customer charge equivalent by dividing the $120.00 customer charge for 12 months by 1,000, or $0.12. The cost of 1,000 Ccf of natural gas, calculated this way, would be $1,427, whereas the price of the equivalent of 1,000 Ccf of propane would be $1,834. The price of propane would have to drop to approximately $1.307 per gallon to be competitive with natural gas. However, the wholesale price of propane March 12, 2007, in Missouri was $1.055.

Also, the Company has franchise agreements with Lebanon, Licking, and Houston. The Company stated in a pleading filed on May 22, 2007, that it was withdrawing its request for a certificate of convenience and necessity to serve Mountain View since this municipality was not interested in receiving natural gas service at this time. 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 stipulation and agreement in Commission Case No. GA-94-127, in which the Commission noted in its order "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].

Also, in a pleading filed by the Missouri Propane Gas Association ("MPGA"), the MPGA has argued the Lebanon franchise may not be valid since no ratification vote has been held in Lebanon. On May 22, 2007, SMNG filed a response which demonstrated that no ratification election was required under the procedures outlined in Section 88.251 RSMo. While the MPGA has questioned the validity of the franchise from the City of Lebanon, the Commission has received the verified statement concerning the affidavit which is what Section 393.170.2 and Commission rule 4 CSR 240-3.250 require. According to Applicant, in order to avoid potential and unnecessary delays from the litigation threatened by the MPGA, the City of Lebanon has set the issue for a vote in August which will resolve the ratification election issue. Having reviewed the pleadings filed by the MPGA and SMNG's response to same, the Staff believes the Commission may reasonably choose to issue a conditional certificate and move forward based on the Company's affidavit. Since a question has arisen concerning the franchise agreement, Staff recommends the Commission condition the CCN on a favorable vote of the citizens of Lebanon. If the Company chooses to proceed with construction of the lateral pipeline from Marshfield to outside the city limits of Lebanon prior to the election, it may do so, although it does so at its own risk. The distribution system within the city limits of Lebanon would be constructed only following the ratification election. This approach will enable SMNG to build the lateral pipeline in a timely fashion if it chooses to proceed in this manner and enable SMNG to serve the City of Lebanon, in the upcoming winter heating season, assuming the voters of the municipality approve the franchise.

Financing Recommendation

SMNG seeks an order of the Commission granting the Applicant the 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. The proceeds of the equity capital and debt securities will be applied to working capital, capital expenditures and other lawful corporate purposes, including the proposed expansion of its service area to include Lebanon, Houston, and Licking, Missouri, and other communities within Applicant's existing service area.

At this time Staff does not recommend approval of SMNG's financing Application in Case No. GF-2007-0215. Because of concerns Staff had about SMNG's financial statements, Staff had been pursuing continued discovery in relation to these financial statements and SMNG's operations in general. Staff believed this information was important considering the pro forma financial statements it analyzed in the acquisition case, Case No. GM-2005-0136 were premised on what Staff understood to be the purchase accounting treatment of the acquisition. However, based on Staff's review of current audited financial statements, this transaction was accounted for in a different manner, which Staff still believes needs to be addressed at least for purposes of determining if SMNG's Annual Report filed in April 2007 with the Commission is legitimate. Staff will investigate this matter in a separate proceeding. 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, Staff believes it is prudent to withhold its approval of the financing Application until it receives the terms and conditions proposed by the ultimate investors to evaluate whether the investment opportunity has been fairly represented. An argument could be made that Staff should require this information even if it didn't have increased concerns about the Applicant's financial statements.

SMNG has provided information to Staff that represents that 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. SMNG is currently still engaged in definitive negotiations with several aforementioned potential investors and once its negotiations are complete will file an amendment to its Application providing the specific identity of the investor(s), a summary of their experience with utility investments, any required amendments to existing contracts to allow new investor participation, any new contracts required to allow new investor participation, any drafts of proposed indentures, the terms and conditions required by these investors, and the documents (whether financial statements or draft legal documents) that SMNG or any of its affiliates provided to the potential investors and any correspondence concerning questions about SMNG's or any of its affiliates' financial statements. After SMNG has filed this information Staff will issue its final recommendation relative to SMNG's financing application.