

MEMORANDUM

TO: Missouri Public Service Commission Official Case File
Case No. GF-2009-0057, Missouri Gas Utility, Inc.

FROM: David Murray, Financial Analysis Department

/s/ David Murray 10/30/08
Project Coordinator / Date

/s/ Bob Berlin 10/30/08
General Counsel's Office / Date

SUBJECT: Staff Recommendation to conditionally approve the Application of Missouri Gas Utility, Inc. for authority to issue up to and including \$7 million of indebtedness, in one or more transactions, and to, among other things, execute and deliver a mortgage and security agreement to secure said indebtedness.

DATE: October 30, 2008

Missouri Gas Utility, Inc.

1. (a) **Type of Issue:** (i) \$5 million loan agreement by and between Missouri Gas Utility, Inc. ("MGU") and Summit Utilities, Inc. ("Summit"); (ii) a reimbursement agreement, which includes a \$2 million line of credit, by and between MGU, Summit, and US Bank National Association ("US Bank"); (iii) a note and mortgage from MGU to US Bank; (iv) a trust agreement by and between Summit, MGU and The Bank of New York, Mellon, N.A.; and (v) a general security agreement by and between MGU and US Bank.
- (b) **Amount:** \$5 million through the loan agreement and \$2 million through the line of credit.
- (c) **Rate:** The interest rate on the loan shall be variable based on a margin of approximately 5 basis points over 30-day Libor (London interbank offered rate), an additional 10 basis points for remarketing of the bonds and an additional 125 basis points for a letter of credit from US Bank. The interest rate on the line of credit is anticipated to be based on the Prime Rate, which was 4.50 percent at the time Staff drafted this recommendation.
2. **Proposed Date of Transaction:** As soon as possible.
3. (a) **Statement of Purpose of the Transaction:** The Applicant proposes to use the long-term loan proceeds for its ongoing construction program, to discharge outstanding long-term indebtedness and other corporate purposes. The construction program includes expenditures made, or being made, in recent Commission authorized certificated areas in the communities of Ridgeway (Case No. GA-2008-0321), Pattonsburg (Case No. GA-2008-0322) and

Appendix A

Jamesport (Case No. GA-2008-0348). The \$2 million line of credit will be used for periodic working capital needs and bridge financing for construction costs.

(b) **From a financial perspective, does Staff deem this purpose reasonable?**

Yes X No

4. **Type of Transaction:** Secured indebtedness through various loan agreements for both the \$5 million long-term indebtedness and the \$2 million line of credit.

5. **Copies of executed instruments defining terms of the proposed transaction:**

 (a) If such instruments have been previously filed with the Commission, a reference to the Case Number in which the instruments were furnished.

 X (b) If such instruments have not been executed at the time of filing, a requirement to file the final terms and conditions will be made.

 (c) If no such instruments are either executed or to be executed, a statement of how the securities are to be sold.

6. **Certified copy of resolution of the directors of applicant, or other legal documents authorizing the proposed transaction reviewed:**

Yes X No

7. **Capital expenditure schedule reviewed:**

Yes X No

8. **Journal entries are required to be filed by the Company to allow for the Fee Schedule to be applied:**

Yes No X

9. **Recommendation of the Staff:**

 Grant by session order (see Comments)

 X Conditional Approval granted pending receipt of definite terms of transaction (see Comments)

- _____ Require additional and/or revised data before approval can be granted (see Comments)
- _____ Formal hearing required (see Comments)
- _____ Recommend dismissal (see Comments)

COMMENTS:

Background. MGU is a corporation duly incorporated under the laws of the State of Colorado with its principal office located at 7810 Shaffer Parkway, Suite 120, Littleton, Colorado 80127. MGU provides natural gas service in the Missouri counties of Harrison, Daviess and Caldwell. On December 18, 2004, the Commission authorized MGU to acquire the natural gas systems in the towns of Gallatin and Hamilton in Case No. GO-2005-0120. MGU is a wholly-owned subsidiary of Summit (f/k/a CNG Holdings, Inc.), a Colorado corporation. To Staff's knowledge, MGU's operations are limited to regulated natural gas distribution operations in Missouri. Summit is a private corporation with many private shareholders. However, one private shareholder, ** _____ ** of the common equity as of January 7, 2008. According to Summit's March 31, 2008 annual audited financial statements, Summit has five wholly-owned subsidiaries: Colorado Natural Gas, Inc. ("CNG"), MGU, Colorado Water Utility, Inc. ("CWU"), Deer Creek Water, LLC ("DCW") and Wolf Creek Energy, LLC ("WCE"). CNG is an operating natural gas distribution company subject to the jurisdiction of the Public Utilities Commission of the State of Colorado ("CPUC") with respect to its retail gas operations. CWU was formed in 2005 and operates a local water distribution system near Parker, Colorado and is currently subject to the jurisdiction of the CPUC. DCW was formed in April 2005 and holds the rights to water sold to CWU. WCE purchases natural gas, then contracts to transport the gas across the Colorado Interstate Gas Company system and another utility's system. The gas is sold to three customers at the point of transfer between the other utility and CNG.

MGU's Application requests Commission authority to encumber its Missouri utility assets as part of a transaction which will ultimately involve the issuance of variable-interest-rate revenue bonds by its parent company, Summit. Because MGU is not a Missouri corporation, it is not requesting authority to directly issue debt pursuant to Section 393.200, RSMo and 4 CSR 240-3.220 and consequently was not required to file the documents consistent with this law and regulation. MGU is requesting authority to secure this debt through the issuance of various documents that allow a lien on its Missouri utility assets. Although there is no explicit specification of the standard to be used in such cases, Staff has historically applied the "standard of not detrimental to the public interest" in such instances and will do so in this case as well.

Transactions. MGU is requesting Commission authority to create a lien or encumbrance on its Missouri properties in order to secure payment of up to \$7 million of possible debt proceeds. \$5 million of the request is for a letter of credit (LOC) that will be provided by US Bank in conjunction with the variable-interest-rate revenue bonds and \$2 million is for the line of credit US Bank will provide directly to MGU. The line of credit is different than the letter of credit. A line of credit is much like a credit card in which MGU can draw on this line for immediate cash needs either for working capital purposes or to fund construction costs before it is able to issue long-term capital to refinance at least a portion of its outstanding debt under its line of credit. The letter of credit is a contract between US Bank, MGU and Summit that requires MGU to reimburse US Bank for payments it makes to the bondholders and for Summit to guarantee these payments. This type of arrangement allows the debt to be rated at the same level as the bank, which lowers the cost. In the proposed transaction, US Bank charges an annual fee of 1.25 percent for the letter of credit.

Appendix 1, attached to MGU's Application, provides a diagram of how the two transactions will be structured and the role of Summit in the proposed debt transaction. However, because the transactions are not only distinct and different in terms of the length of maturity of the debt, but also in terms of the parties involved, Staff will explain each transaction separately.

\$5 million LOC. The Application states that \$5 million in bonds will be issued directly by Summit with the The Bank of New York Mellon serving as the Bond Trustee. Although the Application requests authority to encumber \$5 million in assets for the LOC, the loan documents attached to the Application indicate the amount will be \$4.715 million. Staff recommends that the approval of the proposed lien be limited to this amount. The proceeds will then be loaned to MGU by means of the Series 2008B Loan Agreement between Summit and MGU. Interest payments to the bondholders will be made by US Bank which is providing the LOC. This LOC allows Summit the ability to issue the bonds at a cost based on the credit quality of US Bank. It is Staff's understanding that these bonds will be rated by a credit rating agency. Staff will condition its recommended approval of the proposed financing on MGU submitting this rating when it is available. Based on the Reimbursement and Pledge Agreement between MGU, US Bank and Summit, MGU will reimburse US Bank for the payments it makes to the bondholders and also pay an additional fee of 1.25 percent for the LOC. The interest rate charged on the bonds is anticipated to be 5 to 10 basis points over the 30-day Libor rate. However, it is possible that this interest rate margin may increase to higher levels at times. For instance, Summit personnel indicated that during the recent tightness in the credit markets, the spread over 30-day Libor was as high as 143 basis points for MGU's sister company, CNG. Fortunately, this spread dropped to 25 basis points in a matter of a week. Regardless, these rapid changes in the margin charged over Libor, coupled with the volatility in Libor itself, creates greater cash flow risk to MGU and ultimately and more importantly, Summit. In the past, Summit has been able to mitigate the risk due to the volatility of Libor for \$29.6 million of bonds issued for its CNG operations by entering into an interest rate collar that effectively limits the high end of the Libor rate to 6 percent and the low end to 4.725 percent. The interest rate collar on these bonds expires in April 2011.

Although MGU indicated in response to Staff Data Request No. 0012 that its directors had decided to enter into a straight interest rate swap agreement to convert all of the proposed new bonds into a fixed rate for a period of at least three to five years, MGU has since verbally communicated to Staff that this may not be possible due to current credit market conditions. Staff is concerned about this inability to hedge the variable-interest-rate exposure during a period of extremely volatile interest rates. Additionally, because MGU plans to use part of this variable-interest-rate debt to refinance approximately \$1.3 million of existing fixed rate debt, this will eliminate the certainty of the interest rate on this existing debt. The cost of debt embedded in MGU's current rates is approximately 6.80 percent based on MGU's embedded cost of debt in its last rate case, Case No. GR-2008-0060. The existing fixed interest rate debt's maturity is in 2010, which would require a balloon payment of approximately \$1.2 million at maturity. Consequently, MGU would need to seek capital to refinance this loan in the near future irrespective of its current proposal to issue debt to finance expansion of its current system.

If MGU were a stand-alone company, Staff believes that MGU's inability to hedge its interest rate exposure would be of much greater risk to MGU's ability to attract capital for future capital expenditure needs. However, one of the advantages of MGU being a part of a holding company is the diversification of risk that may be incurred at any one subsidiary because of market conditions at the time capital is needed. For this reason, Staff believes its analysis of the proposed transaction, and the risks associated with it, should not assume MGU acts as a stand-alone entity because this would ignore the reality of MGU's affiliation with Summit. Unfortunately, due to regulatory issues in connection with financing applications, utility companies usually only provide information on the stand-alone entity as if it existed independently. However, when it comes to investors' evaluation of the risk of investing in a business, these affiliations are of extreme importance to their evaluation. Therefore, if the Staff is to evaluate whether the proposed transaction may be detrimental to the public, it would seem foolhardy to ignore these circumstances. Besides, this is how Standard and Poor's (S&P) evaluates the creditworthiness of Missouri's utilities, whether these affiliate relations are positive or negative to the Missouri utility's credit quality. Unless a subsidiary is legally ring-fenced from its affiliates, Staff sees no other option than to analyze a transaction as to how it impacts the consolidated creditworthiness of the parent company. In this case, the risk of MGU not being able to hedge its interest rate risk at this time does not appear great because a significant amount of debt held at Summit's CNG subsidiary is hedged.

If Summit is unable to hedge the MGU debt, because the proposed amount of debt at MGU should only account for 10.75 percent of the total consolidated Summit debt (\$4.715 million divided by \$43.94 million), this should not have a large impact on Summit's consolidated financials. In response to Staff Data Request No. 0012, MGU indicated that Summit had hedged 75.4 percent of the variable-interest-rate debt at its CNG subsidiary. If Summit decides not to hedge MGU's debt or markets make it uneconomical to do so, then Summit would be hedged on 67.36 percent of Summit's variable-interest rate debt. Consequently, the incremental impact on Summit's overall risk exposure should be minimal.

In the instant case, Staff believes MGU's affiliation with Summit is advantageous to its ability to incur the financial risk associated with the proposed transaction. However, it is also possible that financial and business risk incurred by Summit at its other operations may become detrimental to MGU's ability to attract capital. Currently, it appears that Summit's current business and financial risk is fairly consistent with that of MGU. However, as is apparent from the Commission's experience with other Missouri utilities' credit quality being impacted by risks that are not affiliated with the Missouri regulated utilities, this situation can change due to risks incurred by the holding company and its other subsidiaries. For this reason, Staff believes it is prudent to require MGU to seek a commitment from Summit to capitalize itself with no more debt capital as a percentage of total capital as compared to how it capitalizes MGU. However, this assumes that Summit maintains its current business strategy of predominately being an expanding natural gas distribution utility.

\$2 million Line of Credit. MGU is also requesting the authority to place a lien or encumbrance on its assets to secure a \$2 million line of credit. The line of credit is a direct source of capital for MGU for immediate capital needs. US Bank is the primary source of funds and the cost of these funds is based on US Bank's assessment of MGU's and Summit's creditworthiness. MGU makes interest payments on the outstanding line of credit balance directly to US Bank. The proposed line of credit will be secured by MGU's utility properties.

Staff issued Data Request No. 0008 to determine MGU's needs for the \$2 million line of credit. In response to this data request, MGU indicated that the line of credit would be used to cover periodic working capital needs, such as gas storage, accounts receivable, underrecovery of purchase gas costs, gas purchases and internal growth pending subsequent bond issuances. Although Staff does not dispute the need for short-term capital to fund internal growth, Staff does not consider this a working capital need. Funds used for construction to grow the company would not be classified as working capital, but rather a long-term investment. This is also important to consider because debt incurred for construction is permanent and will not be paid down due to a reduction in working capital from cash receipts. This justifies the inclusion of this debt in pro forma financial statements. However, as long as the funds from the line of credit are used exclusively for MGU's operations and not for any of Summit's other operations, Staff believes the stated uses are appropriate.

The line of credit with US Bank may be renewed annually. The initial interest rate on the line of credit is anticipated to be based on the Prime lending rate, which at the time of the filing of the Application had been 5 percent, but has since dropped to 4.5 percent.

Pro Forma Financial Impact of Proposed Debt. MGU attached a balance sheet to its Application (Appendix 2) showing pro forma adjustments for the proposed issuance of \$4.715 million of variable-interest-rate revenue bonds. The pro forma balance sheet did not reflect any additional debt associated with the line of credit. Staff believes for purposes of analyzing the possible impact of the proposed transaction at least an average amount of short-term debt should be

shown for a “likely” scenario, but in order to be conservative in its assessment of the proposed transaction, Staff will assume the line of credit is completely drawn down. MGU’s pro forma balance sheet also showed anticipated increases in retained earnings based on 2009 projected income. Staff issued several data requests to obtain additional and more detailed information that would allow it to analyze the impact of the proposed financing more thoroughly. Staff requested financial information for both MGU and Summit.

Schedules 1 and 2 attached to this recommendation show Staff’s analysis of the possible impact the proposed financing may have on MGU’s and Summit’s ability to meet its debt service obligations.

The assumptions made for the pro forma impacts are of critical importance in determining the possible impact of the proposed financing on MGU’s and Summit’s financial condition. However, with the recent tightening and volatility of the credit markets, it is much more difficult to make reliable assumptions, at least in regard to the cost of the debt to MGU and Summit. For example, in the short time since MGU filed its Application on August 25, 2008, the 30-day Libor rate had increased by as much as 200 basis points, but has fallen approximately 100 basis points from its peak. Although Staff hopes that conditions in the credit markets improve and 30-day Libor moves toward a more normal level, which is usually fairly close to the targeted Federal Funds rate, for purposes of assessing the possible impact of the proposed transaction, Staff believed it was important to assume that the 30-day Libor rate would remain high, if not reach the levels achieved in 2007 during a Fed induced credit tightening cycle. Consequently, Staff’s assumed interest rate was 2.86 percent higher than that assumed by MGU. Although MGU will not likely incur annualized interest expense based on the full amount of the requested line of credit, Staff made this assumption to be conservative because this was the amount requested in the Application. The interest rate charged on the line of credit is based on the Prime rate (currently 4.5%). If these assumptions are realized, then the proposed transaction would have a significant impact on MGU’s stand-alone financial ratios (see Schedule 1). However when considering the impact of the proposed transaction relative to Summit, the proposed transaction will have a much smaller impact on the parent company’s consolidated financials, even if the above assumptions are realized (see Schedule 2).

Because of the small relative impact the proposed transaction will have on Summit’s consolidated financial condition, Staff does not believe the proposed transaction would be detrimental. However, Staff’s position is premised on Summit continuing to be capitalized consistent with the proposed capitalization for MGU and Summit’s business risk remaining consistent with its current operations.

OTHER ISSUES:

The Staff has verified that the Company has filed its annual report and is not delinquent on any assessment. The Staff’s Budget and Fiscal Services Department has reviewed the circumstances in this finance case and because the Company is not a Missouri corporation the fee schedule, as set forth in Section 386.300 RSMo, 2000, in accordance with 4 CSR 240-3.615(1)(F), does not apply.

RECOMMENDED CONDITIONS:

Staff recommends that this Application be approved with the following conditions:

1. That nothing in the Commission's order shall be considered a finding by the Commission of the value of this transaction for rate making purposes, which includes, but is not limited to the capital structure, and that the Commission reserves the right to consider the rate making treatment to be afforded these financing transactions and their effect on cost of capital, in any later proceeding.
2. That the Company file with the Commission any information concerning communication with credit rating agencies concerning the proposed financing.
3. That the Company file with the Commission all final terms and conditions of the proposed financing, including, but not limited to, the aggregate proceeds received, price information, and estimated expenses.
4. That MGU enter into an agreement with Summit Utilities, Inc. whereby Summit commits to:
 - (a) be capitalized with no more debt capital as a percentage of total capital as compared to how it capitalizes MGU and,
 - (b) keep Summit Utilities, Inc.'s business risk shall remain consistent with its current operations.

The debt to capital ratio shall be as defined in the Reimbursement and Pledge Agreement by and among MGU, Summit and U.S. Bank National Association. MGU shall file with the Commission both Summit's and MGU's fiscal-year end annual audited financial statements to ensure compliance with this condition.

5. That all future funds acquired through issuance of securities under this application shall be used exclusively for the benefit of Missouri Gas Utility, Inc.'s regulated operations.
6. That the amount authorized for purposes of the requested lien or encumbrance shall be limited to \$6,715,000.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of Missouri)
Gas Utility, Inc., for Authority to Enter into)
Certain Debt Instruments and to Issue up to)
and Including \$7,000,000 of Indebtedness, in)
one or More Transactions, and to, Among)
Other Things, Execute and Deliver a)
Mortgage and Security Agreement to Secure)
Said Indebtedness.)

Case No. GF-2009-0057

AFFIDAVIT OF DAVID MURRAY

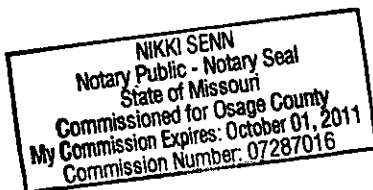
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)


David Murray, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Recommendation in memorandum form, to be presented in the above case; that the information in the Staff Recommendation was developed by him; that he has knowledge of the matters set forth in such Staff Recommendation; and that such matters are true and correct to the best of his knowledge and belief.



David Murray

Subscribed and sworn to before me this 30th day of October, 2008.





Notary Public

MISSOURI GAS UTILITY, INC.
CASE NO. GF-2009-0057

**Selected Financial Ratios
for Missouri Gas Utility, Inc.**

	2008 Actual	After Rate Increase	Pro Forma	S&P Benchmark Bounds for Investment Grade Credit Rating ¹	Loan Covenant Minimum
<u>RATIO ANALYSIS</u>					
Funds From Operations Interest Coverage:	2.97 x	4.62 x	2.06 x	2.0 x	
EBITDA/Interest Coverage	2.42 x	4.78 x	2.10 x	NA x	2.25 x
Funds from Operations to Total Debt:	8.84%	16.25%	11.07%	10 %	
Total Debt to Total Capital:	57.08%	57.08% ^{2.}	68.40% ^{2.}	60 %	

Notes:

1. Source: Standard & Poor's RatingsDirect, "U.S. Utilities Ratings Analysis Now Portrayed In The S&P Corporate Ratings Matrix", November 30, 2007.

2. Not adjusted for retained earnings from income statement.

**MISSOURI GAS UTILITY, INC.
CASE NO. GF-2009-0057**

**Selected Financial Ratios
for Summit Utilities, Inc.**

	2008 Actual	Pro Forma After Rate Increase	Final Pro-forma	S&P Benchmark Bounds for Investment Grade Credit Rating ¹
<u>RATIO ANALYSIS</u>				
Funds From Operations Interest Coverage:	2.97 x	3.11 x	2.83 x	2.0 x
EBITDA/Interest Coverage	2.94 x	3.08 x	2.82 x	NA
Funds from Operations to Total Debt:	12.52%	14.50%	12.31%	10 %
Total Debt to Total Capital:	47.56%	47.56% ^{2.}	51.55% ^{2.}	60 %

Notes:

1. Source: Standard & Poor's RatingsDirect, "U.S. Utilities Ratings Analysis Now Portrayed In The S&P Corporate Ratings Matrix", November 30, 2

2. Not adjusted for retained earnings from income statement.