BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the matter of the Application for Authority of Sendero SMGC LP Acquisition Company, and Sendero SMGC GP Acquisition Company to purchase the partnership interests of DTE Enterprises, Inc. and DTE Ozark, Inc. in Southern Missouri Gas Company, L.P., and for Southern Missouri Gas Company, L.P. to execute a Deed of Trust, Security Agreement and Financing Statement to secure a loan to to complete the transaction.	)))))))))	Case No. GM-2005-0136

STAFF'S MEMORANDUM IN SUPPORT OF THE

NONUNANIMOUS STIPULATION AND AGREEMENT

COMES NOW the Staff of the Commission (Staff) and submits its Memorandum to the Commission in Support of the Nonunanimous Stipulation and Agreement (Stipulation and Agreement) filed in this case on April 6, 2005.

I. Introduction

Staff has worked diligently with Sendero SMGC LP Acquisition Company, LLC, Sendero SMGC GP Acquisition Company, LLC (collectively "Sendero"), DTE Enterprises, Inc., and DTE Ozark, Inc. (collectively "DTE") ("Sendero" and "DTE" collectively referred to as "Applicants") to be able to come to an agreement that addressed most of the Staff's concerns.

In this case, DTE, which currently owns and operates Southern Missouri Gas Company ("SMGC"), proposes to sell its partnership interest in SMGC. One of the major changes that occurs because of this transaction is that ownership will shift from a large, traditional public utility owner, DTE, to ownership by a start-up company, Sendero, which has limited assets and is financed by private equity ownership. According to limited liability company membership documents, CHx, the private equity firm, appears to be able to exert an extensive amount of control over the operations of SMGC.

One of the Staff's concerns is the economic feasibility of the system. This has been an on-going concern with the system that does not change with the change in ownership. There are several factors that have contributed to the financial difficulties of the system, including that it was more expensive than estimated to build and that fewer consumers have converted to natural gas than anticipated due, in part, to competition with propane. In the original Certificate of Convenience and Necessity (CCN) Order, the Commission placed the risk of the economic feasibility of the system squarely on the owners so Staff wants to ensure that the continuing risk of the financial viability of the system not now be shifted to the customers. Sections 1, 8 and 11 and Attachments A and B in the Stipulation and Agreement in this case, among others, are designed to assure that most of the risk of financial viability remain on the owners as ordered in the original CCN. The significant reduction in interest expense, however, should improve Sendero's likelihood of making the system economically viable. Additionally, Sendero has agreed to a three (3) year rate moratorium, and has also agreed to a condition that there will be no increase in the cost of capital as a result of this transaction.

To avoid shifting to customers, in a subsequent rate case, the risk that the Commission placed on the original owners in the CCN Staff will actively oppose any increase to rate base values that are not fully supported. In addition, in the original CCN case Tartan's estimate of the rate of conversion of 70% was challenged and, as a result, Tartan agreed to accept the risk that its estimated conversion rate of 70% was not accurate by agreeing to impute volumes of at least 1,797,000 Mcfs in future rate cases. Staff believes that this condition of the original CCN should not change with this sale.

Sendero has indicated its intention to aggressively market the system in an attempt to expand, and Staff hopes that Sendero succeeds, but the original CCN placed certain conditions on the company in case the system did not meet revenue expectations. Extensive discussions indicate that Sendero understands the risks and also understands that Staff will resist attempts in the future to shift the risk to customers by claiming that the rate base has a higher value than can be justified or arguing that the imputed volumes condition should end.

The Stipulation and Agreement has been entered into by the Staff with conditions that are designed to address the Staff's concerns with this transaction. The Stipulation and Agreement represents Staff's best efforts to protect the public interest from potential detrimental impacts that may arise as a result of this transaction. Sendero has accepted the terms and conditions of the Stipulation and Agreement, so that Staff is able to recommend that the Commission approve the transfer.

II. Brief History of the Southern Missouri Gas Company System

On October 15, 1993, Tartan Energy Company, L.C. (Tartan) d/b/a Southern Missouri Gas Company ("SMGC") filed an application seeking a CCN authorizing it to construct, install, own, operate, control, manage, and maintain gas facilities and to render gas service as a LDC in the incorporated municipalities of Cabool, Houston, Licking, Mountain Grove, Mountain View, West Plains, Ava, Mansfield, Marshfield, Seymour, and Willow Springs, Missouri, and their surrounding areas in Wright, Texas, Howell, Webster, Greene and Douglas Counties. On September 16, 1994, the Commission issued a Report and Order granting Tartan a CCN. (Case No. GA-94-127.)

On May 9, 1995, Tartan filed an application for a CCN authorizing it to construct, install, own, operate, control, manage, and maintain gas facilities, and to render gas service in and to residents of certain areas of Greene, Wright and Webster Counties, including the incorporated Municipalities of Rogersville, Fordland, Diggins, Norwood and Seymour, Missouri. The Commission granted a Certificate of Convenience and Necessity by order effective on September 26, 1995. (Case No. GA-95-349)

On February 8, 2000, SMGC submitted an informal rate case to the Commission, with tariffs reflecting increased rates for natural gas service provided to customers in the Missouri service area. The proposed tariffs were designed to produce an annual increase in SMGC's revenues of approximately six percent (6%) or $390,000. Staff performed an analysis of SMGC's requested increase and stated that Staff supported a stipulation to increase rates. Staff's accounting analysis resulted in a higher revenue requirement than sought by SMGC. The Commission approved the Stipulation and Agreement effective on November 26, 2000. (Case No. GR-2000-485)

DTE acquired all of the partnership interests in this property when the Commission approved DTE's application to buy the final partnership interests of Tartan and issued its Order in Case No. GO-2003-0317 in May 2003.

A. DTE is the current owner.

DTE is a large electric and gas distribution company with over 100 years of experience serving over 1.2 million gas customers in the Detroit area. DTE also owns
Citizens Gas Fuel Company, which has about 17,000 customers, also in Michigan.

B. Southern Missouri Gas Company is to be sold.

SMGC is a Local Distribution Company (LDC), and a Missouri Limited Partnership that owns and operates a natural gas transmission and distribution system located in southern Missouri that serves approximately 7,500 residential, commercial and industrial customers.

<u>C. Sendero is the proposed purchaser.</u>

The Sendero companies consist of Sendero Capital Partners, Inc., Sendero Asset Management, LLC, Sendero SMGC GP Acquisition Company, LLC, and Sendero SMGC LP Acquisition Company, LLC. Sendero Capital Partners, Inc, is a privately held investment company designed to acquire and operate various energy-related assets and/or companies. Sendero Asset Management, LLC, was established for the purpose of providing asset management services to companies it acquires. Sendero SMGC GP Acquisition Company, LLC, and Sendero SMGC LP Acquisition Company, LLC, were recently established for the sole purpose of owning the respective general and limited partnership interests of the SMGC entities. CHx Capital, LLC (CHx) is a wholly owned subsidiary of Aspect Energy and is a privately held investment company. CHx will own approximately 94% of the Sendero Acquisition Entities and will have a controlling interest in both entities as well as the Advisory Boards. CHx is contributing the majority of the equity for this purchase. That said, the total equity contributed to this transaction, as a percentage of the purchase price, is less than 17%. This led to the conditions in the Stipulation and Agreement to address Staff's concerns, noted above, that, while this system was backed by the extensive financial resources of DTE, it will now be owned by a private equity financing company, CHx, and that the new owner, Sendero, has quite limited financial resources in comparison with DTE.

III. The Proposed Transaction

Below is the Staff's discussion of the Stipulation and Agreement and why Staff can support the proposed transfer with these conditions.

A. No increase in the cost of capital

The first condition in the Stipulation and Agreement is that the cost of capital for SMGC will not increase as a result of this transaction. Staff wanted this condition because DTE's current form of financing involves an inter-company notes receivable. The proposed transaction leverages the SMGC assets by using them as collateral for a loan with an external bank. The risk of default, therefore, has been changed from an internal obligation of DTE, to an external obligation. Overall, the DTE financial resources that backstopped SMGC's cash flow needs are being replaced mainly by SMGC's own more limited resources. While SMGC's cost of capital will likely increase, customers will be protected from detriment and will not see an increase in rates due to an increase in the cost of capital as a result of this transaction.

B. The impairment write-downs

DTE has taken a total of three (3) asset impairment write-downs, for a number of reasons. The first impairment write-down of $8,500,000 was taken by MCN (now DTE Enterprises), during 1998. A second impairment write-down of approximately ** __________ ** was taken during December 2001 by DTE. DTE took an additional asset impairment write-down of $7,000,000 during 2004. The tax benefits associated with the partnership interests will be taken at the time of the sale of the partnership interests to Sendero in this case.

The asset impairments that have been taken by DTE have been recorded for financial purposes on the corporate books; however, because of differences in accounting practices, the impairments have not been recorded on the regulated books and records of the operating company, SMGC.

Staff opposed transferring the partnership interest in SMGC property to Sendero at the original cost, as if the asset impairments had not taken place, because that would potentially

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allow the purchasing company to request rates on plant that has been written-down as impaired assets. Transferring the assets to Sendero at the original cost when DTE has taken three asset impairment write-downs, would be, in effect, to transfer the excess costs incurred by the previous and existing owners of this property, to SMGC's customers. Moreover, based on the price that Sendero is paying for these properties, Sendero itself has recognized this write-down in the purchase price of the assets that it negotiated to buy from DTE. SMGC's pro forma financial statements included in its First Amended Application, reflect valuation of the net plant in service assets at ** ______________** which is slightly lower than the ** ____________** purchase price paid by Sendero. Any shift in the risk of building and operating the natural gas systems to the customers, would be a significant detriment to those customers. As a result of the conditions on the transfer, the assets will be transferred to Sendero for financial accounting purposes at the purchase price value.

The Stipulation in this case was made with the full understanding by the Parties that the valuation of the assets in the future would be subject to disagreement. Sendero understood that valuation of assets would continue to be an issue with this system when it entered into the Stipulation.

The Financial Accounting Standards Board (FASB) accounting requirements for asset impairments and the criteria used to determine when a company should take an asset impairment, are discussed in Attachment A. Also, in Attachment B, is a discussion of a recent case that further explains Staff methodology concerning impairment writedowns where a similar situation was addressed by the company and the Staff. Attachment B to the Stipulation and Agreement discusses the original CCN Stipulation.

C. No acquisition premium will be sought.

As a condition of the Stipulation and agreement, SMGC should not seek recovery of any acquisition adjustment (acquisition premium) now or in any future rate proceedings for the acquisition by Sendero from DTE of SMGC when this transaction is completed. This matter is covered in Section 8 of the Stipulation and Agreement. Also in Section 8, SMGC agreed not to seek recovery of any purported merger savings that would allow either a direct or an indirect recovery of any portion of the acquisition adjustment (acquisition premium) during this case or any future rate proceedings.

D. Financial Analysis conditions

Staff's concern with his transaction is that the risk of default increased significantly since the purchase would be financed with a third-party loan instead of an inter-company loan. Moreover, since no loan arrangements had been finalized at the time of application, it made it difficult for the Staff to determine whether SMGC would be able to meet the ratios required by the terms of the loan. A discussion of Staff's analysis and conclusions is found in Attachment C.

Staff has determined, based on review of pro forma financial information, that SMGC will be able to meet its debt service coverage required by the lender and that, while Sendero is not investment grade, it is a privately held company. Staff does want to review the loan agreement and conditions, and it is part of the Stipulation and Agreement in III.1.D. that Sendero will submit to the Staff copies of all documents finally executed to obtain financing. Sendero has also agreed that there will be no increase in the cost of capital as a result of this transaction, there will not be a rate case for three (3) years and no dividends will be paid during the ** ________________ ** of the loan as set forth in Highly Confidential Attachment A to the Stipulation and Agreement. Staff is, therefore able to recommend this transaction to the Commission.

E. Gas Supply and Transportation conditions

These issues are addressed in Section 6 of the Stipulation and Agreement in this case. SMGC is a small local distribution company that is served by one interstate pipeline transportation company – Southern Star Central (SSC). SMGC has no contract storage service and, therefore, must monitor the balance between its gas supply contracts and its gas demands very closely. SMGC is at the very end of a line segment that is significantly constrained. While SMGC relies on a single interstate transportation company, SMGC has traditionally relied on two (2) or three (3) natural-gas suppliers to meet its gas requirement needs. DTE has occasionally been required to guarantee creditworthiness of SMGC in order for SMGC to be able to contract for gas supply.

DTE is a large electric and gas distribution company serving over 1.2 million natural gas customers in the State of Michigan and has access to numerous gas suppliers. Sendero, in contrast, is a start up company. The Staff does not believe the current SMGC gas suppliers have evaluated SMGC as a "stand-alone" LDC in terms of credit worthiness. Staff does not know what credit assurances the current gas suppliers of SMGC will require from Sendero. Therefore, the Stipulation requires that Sendero not enter into any loan agreement that would prevent it from obtaining letters of credit if necessary to secure natural gas supply.

As a start up company, Sendero has never purchased natural gas under this name. While the proposed owners do have extensive experience in the oil and gas business, based on the information Staff has received, Sendero's existing management has never operated an LDC. The principal owner/manager, Mr. Randy Maffett, has worked as an engineer, pipeline surveyor, operations supervisor, gas sales/supply, project development, corporate development and as a corporate executive with companies including United Gas Pipeline, Mobil Oil Corp., Ladd Gas

Gathering & Marketing, Delhi Gas Pipeline, Altresco Financial Inc., Enron Corp. and RWE Trading Americas. Much of Mr. Maffett's experience is with Enron in the project development area.

To address the concern with the loss of Mr. Scott Klemm, who negotiated the gas supply, evaluated peak day demand requirements, and directed the overall direction of the gas supply function for SMGC, Sendero has agreed in the Stipulation in paragraph 5 to hire full-time local general manager that has at least three (3) years of management experience for a local gas distribution company. In addition, a "transition provision" in the proposed purchase agreement (Section 5.04- Access) gives Sendero the right to hire Mr. Klemm as a consultant for one year after closing. Sendero will also retain the field level operation personnel including an employee that has experience in monitoring the distribution system and nominating gas supply.

Since Sendero is a start up company, Staff was also concerned with Sendero's ability to demonstrate its creditworthiness to its suppliers and provide the guarantees suppliers may demand to contract for gas delivery. Section 1 B of the Stipulation and Agreement is designed to address this issue. Although spot supply (day to day supply) might imply lower credit hurdles, such supply is a minimal portion of most LDC's supply plans because an LDC cannot rely on the availability of sufficient volumes of spot supply to provide firm service obligations when the weather is cold. In addition, these supplies are more volatile and often result in higher gas prices when demand is great. This issue was addressed in the Stipulation and Agreement by receiving Sendero's representation that there would be no restrictions in any financing agreement that will limit SMGC's ability to obtain firm fixed gas supply.

Traditionally, DTE had hedged a significant portion of its normal requirements with fixed price gas supply contracts. Sendero has represented that it is not limited in its ability to obtain such hedging, even in the face of gas supplier creditworthiness requirements. The Stipulation requires that there are no bank or loan restrictions on SMGC's ability to hedge with fixed price physical contracts (as have been traditionally used by DTE to hedge); and that Sendero will not enter into a financing agreement that restricts Sendero's or SMGC's ability to get fixed price contracts for natural gas..

F. Actual Cost Adjustment process commitments will continue.

Pursuant to existing rules and tariffs, SMGC will be subject to prudence reviews, reliability reviews, and the traditional ACA process. In section 6 of the Stipulation and Agreement, Sendero agreed to ensure that SMGC will continue with the commitments that have been made by DTE/SMGC regarding the historical annual ACA recommendations, ACA Case Stipulations and Agreements and SMGC comments to Staff recommendations. The Procurement Analysis Department has developed a positive working relationship with SMGC and has seen an improvement in SMGC's gas purchasing and planning efforts. Staff hopes to continue that positive relationship with the new owners. In Section 6 of the Stipulation and Agreement, Sendero has agreed to ensure that detailed supply plans will be prepared that include how management will monitor the gas supply procurement function. The plans should also include an evaluation of demand requirements (peak day and varying monthly requirements) along with evaluations of hedging, economic cost evaluations, and gas supply/transportation reliability. The plan itself should be provided to Staff and the Office of Public Counsel by September 15, 2005, and annually thereafter.

Additionally, SMGE will carry forward any ACA over/under recovery balance at the time of sale. This balance would be subject to Staff review and Commission-approved adjustments. The purpose of this requirement is to keep the traditional ACA account balance in place regardless of the transition to a new owner. This condition has been addressed in the Actual Cost Adjustment Issues section of the Stipulation and Agreement in Section 7.

G. Natural Gas Marketing Affiliate will comply with Commission rules.

Certain documents reviewed by the Staff indicated the proposed development of a marketing affiliate and/or asset management affiliate. Initial discussions in one document characterized a situation where a Sendero affiliate would move outside the regulatory process, tailoring new services for end-user customers, and itself becoming a customer of the LDC. The Staff does not believe a marketer can hold transportation (downstream of the city-gate) on the LDC's system, but instead the marketer must be separate and apart from the LDC. Additionally, the marketer and the LDC must follow the affiliate transaction rule and Sendero has agreed to do so. All gas supply, transportation, and storage contracts must be held in the LDC's name and remain under the regulated LDC's control. Sections 3, 14 and 16 of the Stipulation and Agreement address this concern.

H. The Management Agreement is allowable.

The Management Agreement that Sendero proposes is similar to the Agreement between SMGC and DTE. Both Management Agreements place significant power and control in the Manager, including the responsibility for all gas purchasing and transportation. Additionally the management fee is ** ________________________________ ** on an annual basis. While this is not a significant amount, it is still an increase in the costs of a system that has always struggled financially. To resolve this issue, in Section 10 of the Stipulation and agreement, Sendero has agreed to limit the annual amount of increase in this fee.

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I. Affiliate Relationships will be governed by the Commission rules.

The Staff is also concerned about additional affiliate relationships between SMGC and Sendero that have been proposed for future business activities. Sections 2 and 3 D of the Stipulation and Agreement provide conditions designed to address these concerns. Additionally, the Commission must have access to information adequate to determine whether SMGC is in compliance with its affiliated transactions rule. The Staff addressed its concerns with SMGC maintaining data related to affiliate transactions and the allocation of costs between the regulated and non-regulated operations of SMGC and the regulated and non-regulated operations of its owner, Sendero and Manager in Sections 2, and 16 of the Stipulation and Agreement.

The affiliate transactions rule records retention requirement includes providing the Commission access to records of SMGC, Sendero, Manager and any other affiliated entity (e.g., marketing affiliate, asset management affiliate, etc.) for the purpose of ensuring compliance with this rule. These records provide data to support costs allocated between SMGC and any non-regulated business activity. Specifically, SMGC and its affiliates will provide time reporting and associated expenses billed to SMGC and other non-regulated affiliates of Sendero or Manager and all other documents that support the allocation of expenses from these affiliated entities to SMGC. This will allow Staff to audit SMGC's compliance with the Commission's affiliate transactions rule in the future. The allocation of these costs paid by SMGC to Sendero and the Manager are expected to be material and will be reviewed during a rate case proceeding to determine the appropriate amount to be included in the cost of service to SMGC ratepayers.

J. Allocation of costs should be reasonable.

Staff understands that Sendero intends to enter into other ventures. When that happens, SMGC should only receive an appropriate share of Sendero's corporate overhead costs (also referred to as joint and common costs) in the future. Sections 3 and 4 require that Sendero allocate corporate costs (if any) based on factors that faithfully and accurately represent, to the greatest extent possible, the level of actual corporate involvement in the corporate services provided and the actual business unit beneficiaries of the incurred costs.

K. Depreciation will continue as agreed.

There is no controversy concerning depreciation and Section 13 of the Stipulation and Agreement addresses it. For purposes of accruing depreciation expense, Sendero needs to use the rates as currently set forth for SMGC and continue to maintain the Property Unit Catalog (PUC) and Continuing Property Record (CPR) as detailed in 4 CSR 240-40.040 Uniform System of Accounts Gas Corporations, 4 CSR 240-3.235 Filing Requirements for Gas Utility General Rate Increase Requests and 4 CSR 240-3.275 Submission Requirements for Gas Utility Depreciation Studies.

L. Sendero will provide access to records.

In Section 16 of the Stipulation and Agreement Sendero has agreed to provide the necessary books and records for Staff's review or to provide access to that documentation. This includes full information concerning gas purchase and gas trading data, copies of all contracts, and gas supply procurement information for both PGA/ACA audits and also to ensure that safe and reliable service is provided to SMGC customers.

M. Sendero will complete surveillance reports.

Approximately twenty (20) other Missouri utility companies currently provide surveillance reporting on a standardized form, of which, the information is treated as highly confidential. The surveillance report establishes financial reporting requirements that utility companies under Commission jurisdiction follow to allow the Staff to monitor their earnings.

Sendero has agreed to do this in Section 9 of the Stipulation and Agreement. Upon approval of this transaction, SMGC will provide surveillance reports to the Auditing Department of the Utility Services Division on a quarterly basis.

N. Sendero will maintain customer service quality.

In Sections 12 and 16 of the Stipulation and Agreement, the Company agreed to respond to inquiries from the Commission's Consumer Services Department within three (3) business days, except for interruption of service issues, to which it will respond within one (1) business day. Sendero also agreed to provide written notice to all customers in the acquired system regarding the change in Company management and ownership including the Company's address and phone number. The written notice should include information that the system will be subject to regulation by the Missouri Public Service Commission for all matters including rates and service. Customers may contact the Consumer Services Department of the Missouri Public Service Commission at 1-800-393-4211.

SMGC and Sendero further agreed to continue to adhere to all Commission rules and regulations as they relate to service, including abiding by provisions of the Cold Weather Rule, which, among other things, specifies bill payment options and Company responsibility with respect to service disconnections from November 1st through March 31st.

O. Current Rates and Tariffs

Sendero agreed to maintain current rates and tariffs of SMGC's current tariff. Sendero agrees to follow and honor SMGC's current tariff in its entirety. Sendero also agrees ensure that SMGC continues to comply with all Commission rules and regulations as stated in Section 2 of the Stipulation and Agreement.

P. Gas Safety procedures will continue.

Sendero will continue to follow all of the Commission's pipeline safety regulations. This includes having qualified employees, a drug testing program, and 24-7 response to emergency, leak and odor calls.

IV. Legal Basis for Commission Jurisdiction

The Commission has jurisdiction under § 393.190.2 RSMo (2000) to review certain sales by regulated gas corporations. This section provides that:

> No such corporation shall directly or indirectly acquire the stock or bonds of any other corporation incorporated for, or engaged in, the same or a similar business, or proposing to operate or operating under a franchise from the same or any other municipality; neither shall any street railroad corporation acquire the stock or bonds of any electrical corporation, unless, in either case, authorized so to do by the commission. Save where stock shall be transferred or held for the purpose of collateral security, no stock corporation of any description, domestic or foreign, other than a gas corporation, electrical corporation, water corporation, sewer corporation or street railroad corporation, shall, without the consent of the commission, purchase or acquire, take or hold, more than ten percent of the total capital stock issued by any gas corporation, electrical corporation, water corporation or sewer corporation organized or existing under or by virtue of the laws of this state, except that a corporation now lawfully holding a majority of the capital stock of any gas corporation, electrical corporation, water corporation or sewer corporation may, with the consent of the commission, acquire and hold the remainder of the capital stock of such gas corporation, electrical corporation, water corporation or sewer corporation, or any portion thereof."

This section provides the basis for Commission jurisdiction to authorize this transaction.

V. The Standard is not detrimental to the public interest.

Staff evaluated this proposal based on the standard of "not detrimental to the public interest." In establishing this standard, the Supreme Court recognized that one of the most important functions of the Public Service Commission is to balance competing interests and noted:

> To prevent injury to the public, in the clashing of private interests with the public good in the operation of public utilities, is one of the most important functions of Public Service Commissions. It is not their province to insist that the public shall be *benefited*, as a condition to change of ownership, but their duty is to see that no such change shall be made a would work to the public *detriment*. In the public interest, in such cases, can reasonably mean no more than "not detrimental to the public."

In trying to determine whether this proposed transaction might harm the public, Staff defined "public interest" as the nature and level of the impact or effect that the proposed transaction might have on SMGC's Missouri customers. The fundamental concern, and the reason that the Commission has jurisdiction is that the public being served will not be impacted adversely or harmed by this proposed transaction. *Southern Union Co. v. Missouri Pub. Serv. Comm'n*, 289 F.3d 503, 507(8th Cir. 2002).

In the merger case involving KPL and KGE, which occurred in 1991, the Commission identified the "public" as Missouri ratepayers when it said: "[t]he Commission has also found that there is potential for a detrimental effect on Missouri ratepayers from the merger through increased A & G and capital costs . . . ." Case No. EM–91–213, Report and Order p. 12-13. Clearly, the Commission was identifying the

Missouri ratepayers as the relevant "public" in its Report and Order. This is the standard that Staff used to evaluate this transaction.

VI. Conclusion

Staff has agreed to and entered into a Stipulation and Agreement that it believes addresses the potential detriments to consumers. Staff recommends that the Commission approve the transfer in accordance with the provisions of the Nonunanimous Stipulation and Agreement.

Respectfully submitted,

DANA K. JOYCE
General Counsel

/s/ Lera L. Shemwell
Lera L. Shemwell
Senior 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, or transmitted by facsimile or electronic mail to all counsel of record this 14th day of April 2005.

/s/ Lera L. Shemwell______

Attachment A

Asset Impairment

Under Generally Accepted Accounting Principles (GAAP), an asset impairment must be taken under Statement of Financial Accounting Standards (SFAS) 144, Accounting for the Impairment or Disposal of Long-Lived Assets if an asset no longer provides, or can provide adequate revenues to support the asset values. SFAS 144 supersedes SFAS 121, and amends several other standards related to long-lived assets and specifies the accounting and reporting requirements for long-lived assets held for use and long-lived assets held for disposition.

1) <u>Impairment, paragraph 7.</u>

"For purposes of this statement, impairment is the condition that exists when the carrying amount of a long-lived asset (asset group) exceed its fair value. An Impairment loss shall be recognized only if the carrying amount of a long-lived asset (asset group) is not recoverable and exceeds fair value. The Carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). That assessment shall be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability, whether in use (paragraph 19) or under development (paragraph 20). An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset (asset group) exceeds its fair value."

2) <u>Test value, paragraph 16.</u>

"Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall include only the future cash flows (cash inflows less associated cash outflows) that are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset (asset group). Those estimates shall exclude interest charges that will be recognized as an expense when incurred."

3) <u>Assumptions, paragraph 17.</u>

"Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall incorporate the entity's own assumptions about its use of the asset (asset group) and shall consider all available evidence. The assumptions used in developing those estimates shall be reasonable in relation to the assumptions used in developing other information used by the entity for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans, or information communicated to others. However, if alternative courses of action to recover the carrying amount of a long-lived asset (asset group) are under consideration or if a range is estimated for the amount of possible future cash flows associated with the likely course of action, the likelihood of those possible outcomes shall be considered. A probability-weighted approach may be useful in considering the likelihood of those possible outcomes."

4) Fair Value, paragraph 22.

"The fair value of an asset (liability) is the amount at which that asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. However, in many instances, quoted market prices in active markets will not be available for the long-lived assets (assets groups) covered by this Statement. In those instances, the estimate of fair value shall be based on the best information available, including prices for similar assets (groups) and the results of using other valuation techniques."

Attachment B

The Commission has recently dealt with a similar asset impairment issue in the sale of Aquila Inc.'s (Aquila) eastern system to AmerenUE in Case No. GM-2004-0244. In that case, Aquila requested the Commission approve the sale and transfer of its eastern system's natural gas properties serving the cities of Rolla, Owensville and Salem to Union Electric Company d/b/a AmerenUE. Aquila had previously taken write-downs of its natural gas assets of the eastern system for similar reasons as DTE had to on its system, because the assets did not generate sufficient revenues due to low customer conversion rates and high construction costs of the natural gas distribution system. Aquila had to take a further write-down before the sale to UE relating the price UE was willing to pay for the purchase of these properties. The Commission granted the sale of Aquila's eastern system to UE in Case No. GM-2004-0244.

Similar to Tartan agreeing to assume most of the risk of the new natural gas system, Aquila had to bear the risk of developing the natural gas distribution system in Rolla. In Case No. GA-94-325, the Commission authorized Aquila (then going by the name UtiliCorp United Inc.) to build and operate the natural gas system in Rolla but it would do so at its own risk. Aquila would be responsible for the risk of any missed projections in costs and revenues.

When Aquila proposed to construct and build the natural gas systems in the original applications for these cities, the same concerns regarding cost estimates and customer conversions existed as it did for the Tartan system. In that case, testimony was presented that demonstrated concern for the economic viability of the system. Evidence was presented that cast doubt on the cost estimates to construct the distribution system and the number of customers that were expected to take the natural gas product. With respect to the Tartan operations, that the risk of constructing the system would be with Tartan, the Commission made clear that the risk in constructing and operating natural gas in Rolla would be with Aquila. After-the-fact, Aquila found that the construction costs were higher than anticipated and the revenues were lower than forecasted resulting in the requirement to write-down the impaired assets. The revenues were not sufficient to support the costs of the system leading Aquila to sell the eastern system to UE at a loss.

The Aquila case is an example that supports Staff's position that the economics of this transaction, as well as SMGC's level of proposed customer rates, are based upon the purchase price of ** _____________** paid by Sendero for these properties. Accordingly, Staff believes that that this amount is the proper valuation of the property for Sendero. Sendero should book its actual paid investment in the SMGC plant assets in its plant-in-service accounts for regulatory accounting purposes.

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Attachment C

SMGC originally sought approval to borrow ** ___________** in senior debt. This includes ** ____________** in long-term debt to finance the purchase and ** ___________** in a working capital revolver. Sendero has been in negotiations with at least ** ____________ ____**

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The new loan agreement is for ** ______________ ** SMGC currently has a ** ____________** loan balance as of September 30, 2004, with its current parent, DTE. Sendero has stated that this loan will be forgiven upon the completion of this transaction.

** __________________ ** and has committed to lending Sendero up to ** ____________ ** as of the Terms and Conditions sheet that is dated March 2, 2005. ** ____________________ ____ ____ ____ ____ ____ ___________________ **

Sendero does meet the minimum coverage ratios as set forth in the Terms and Conditions, and this will be discussed below. Ratepayer protection is further provided by the prohibition of a general residential rate increase and the prohibition of dividends being paid during the first three years of the loan. However, the Financial Analysis Department does not believe that Sendero is of investment grade.

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** ______ ** requires that the borrower maintain a fixed charge coverage ratio of ** _____ ** during the first six years of the loan, and increasing to ** _____ ** thereafter. The fixed charge coverage is defined by ** ______ ** as the sum of net income, depreciation, amortization, interest expense and other non-cash adjustments, less maintenance expense, divided by the sum of interest expense and the current portion of long-term debt. Sendero's most recent financial statements indicated that the borrower will meet the fixed charge coverage ratio in each of the next 11 years, ranging from a calculated low of ** _____** in 2008 to a calculated high of ** _____** in 2014.

** _______** requires that the borrower maintain a debt ratio of ** _____** during the first two years of the loan, and a debt ratio of ** _____ ** during the next nine years of the loan. The debt ratio is defined by ** ______ ** as total liabilities divided by tangible net worth. Sendero's most recent financial statements indicated that the borrower will meet the debt ratio in each of the next 11 years. The debt ratio for 2005 was calculated to be ** _____** and will gradually improve over the life of the loan to approximately ** _____** in 2015.

** _______** requires that the borrower's cumulative tangible net worth plus permitted subordinated debt to be at least ** ____ _______** during the life of the loan. Sendero projects meeting this net worth condition of ** ___________ ** in 2005 with a pro forma tangible net worth of ** ___________.** The net difference of the amount necessary to meet this condition is approximately ** ________ ** in 2005. Sendero anticipates the net difference in meeting this condition to be in excess of ** _____ ______ ** over the threshold by 2015.

Financial Analysis is very concerned that the proposed transaction will be heavily funded with debt. If the ** _____________ ** loan is approved and there is a ** ____________ ** equity infusion from the partners, the proposed debt ratio will be approximately ** ______ ** and the proposed equity ratio will be approximately ** _______ ** Financial Analysis is concerned that the risk associated with this proposed level of debt could adversely affect ratepayers should Sendero default on the loan.

The Commission recently dealt with the detriment that can occur if a trustee takes over a utility's natural gas distribution operations. In the matter of the Colorado Natural Gas d/b/a Missouri Gas Utility acquisition of natural gas distribution properties in Gallatin and Hamilton through Missouri Gas Utility, Case No. GO-2005-0120, the Commission faced the possibility of the trustee refusing to procure natural gas for the city distribution properties when the city defaulted on lease payments to its creditors.

Consequently, it would appear to be in the public interest to have an investor that is willing and able to attract the necessary amount of reasonably priced capital to acquire the system. ** ____

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There are supplementary concerns regarding Sendero's ability to attract additional capital if Sendero pursues its intended strategy of customer growth, and the necessary capital expenditures associated with such growth, into the three communities that are certificated but are not currently fully operational. Despite its concerns, review of all of the documentation permits the Financial Analysis Department to recommend that the proposed transaction may be approved because of the borrower's projected ability to meet the Terms and Conditions of the loan.