

MEMORANDUM

TO: Missouri Public Service Commission
Official Case No. GO-2019-0216 (Summit Natural Gas of Missouri, Inc.)

FROM: David Murray, Financial Analysis Department, Commission Staff Division

<u>/s/ David Murray 02/22/2019</u>	<u>/s/ Steven Dottheim 2/22/2019</u>
Utility Regulatory Manager / Date	Staff Counsel's Office / Date

SUBJECT: Staff's Recommendation Regarding Summit Natural Gas of Missouri, Inc.'s ("SNGMO") Application for Authority to Pledge its Equity as Collateral for a Loan and to Reorganize.

DATE: February 22, 2019

Introduction:

SNGMO's Application requests, in the alternative pursuant to Section 393.250 RSMo, Commission authority to reorganize, and now Commission authority to approve its reorganization pursuant to Paragraph 16 of the Stipulation and Agreement in Case No. GO-2005-0120, which requires Commission authority to do so. The purposes of the reorganization are to create a new intermediate holding company, Midco, which will issue debt for purposes of capitalizing three subsidiaries, including SNGMO. The terms of this anticipated debt financing requires Midco to pledge SNGMO's equity as collateral. Staff Counsel addresses the legal arguments regarding jurisdiction, whereas the author of this recommendation as a non-attorney addresses the technical aspects and the requirements of the proposed transactions.

Description of SNGMO and Summit Utilities, Inc.:

SNGMO 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. SNGMO provides natural gas service in the Missouri counties of Benton, Caldwell, Camden, Daviess, Douglas, Greene, Harrison, Howell, Laclede, Miller, Morgan, Pettis, Stone, Taney, Texas, Webster and Wright. SNGMO is currently a wholly-owned, direct subsidiary of Summit Utilities, Inc. ("Summit"), also a Colorado corporation. To Staff's knowledge, SNGMO's operations are limited to regulated natural gas distribution operations in Missouri. Summit is a private corporation with one private shareholder, IIF CNG Investment LLC, an investment vehicle owned by JP Morgan Infrastructure Investment Fund (hereinafter referred to collectively as "IIF"). Summit has five direct, wholly-owned subsidiaries: Colorado Natural Gas, Inc. ("CNG"), SNGMO, Summit Natural Gas of Maine, Inc. ("SNGME"), Wolf Creek Energy, LLC ("WCE")

**** Denotes Confidential Information ****

Appendix A

and A.O.G. Corporation (“AOG Hold Co”). AOG Hold Co is a holding company for Arkansas Oklahoma Gas Corporation (“AOG”) (see Schedule 1 for the current corporate structure).¹

Summit has owned gas distribution assets in Missouri since late 2004, when it formed Missouri Gas Utility (“MGU”) to acquire two small municipal gas distribution systems in the cities of Gallatin and Hamilton. IIF later acquired equity ownership of Summit and a company not previously affiliated with Summit, Southern Missouri Natural Gas Company. In early 2012 Southern Missouri Natural Gas Company and MGU merged to form SNGMO. Summit owned CNG when it acquired the MGU systems in 2004. Therefore, CNG has always been a sister company to Summit’s Missouri companies. SNGME became a sister company in 2012, but SNGME didn’t receive significant investment until 2013. In March 2017, AOG Hold Co became a sister company to SNGMO when Summit acquired it and its operating company, AOG.

Creation of Midco to Issue Debt Financing:

The Application outlines plans to create an intermediate holding company, Midco, to issue holding company debt financing to fund investment in the capital structures of CNG, SNGMO and AOG. To date, Summit has not issued holding company debt to finance its current subsidiaries. CNG, SNGMO, AOG Hold Co, and AOG all have various amounts of debt outstanding to third-party investors. SNGME has affiliate debt outstanding to Summit’s equity investor, IIF. Being that the Application indicates the reason for forming Midco is to allow for lower-cost holding company financing for Summit’s subsidiaries, Staff questioned why Summit, the current holding company, could not achieve this goal. In response to Staff Data Request No. 0001, Summit indicated that it could issue holding company debt under its current corporate structure, but it would be at a higher cost than if it were to form an intermediate holding company that would directly own Summit’s more established subsidiaries, which includes SNGMO. Summit would still own SNGME and WCE directly, making them sister companies to Midco (see Schedule 2 for the proposed corporate structure).

Midco plans to issue up to \$225 million of debt, with \$175 million issued upon closing of the credit facility. Upon closing, \$100 million of 10-year debt will be issued at a fixed rate and \$75 million of 7-year debt will be issued at a floating rate. The remaining \$50 million of debt will consist of a 3-year revolving credit facility, which will be used on an as needed basis for purposes of providing liquidity. As collateral for these loans, Midco proposes to pledge its equity interests in its subsidiaries, which would include SNGMO.

¹ <https://www.summitutilitiesinc.com/>

Based on Staff's discovery, analysis and communications with Summit personnel, Midco will use the \$175 million of long-term debt for the following purposes: ** _____

_____. ** Midco would not retire debt currently outstanding at CNG and AOG. Summit has not made a determination as to whether it will refinance CNG's and AOG's debt at the operating company level or retire this debt through proceeds from additional Midco debt. Because CNG and AOG Hold Co have stronger credit metrics than SNGMO, consolidating the three entities creates stronger credit metrics for Midco as compared to SNGMO. To the extent Midco issues more debt than is currently outstanding at the three entities, the credit metrics would deteriorate. However, the anticipated financial covenant relating to capital structure for Midco's loan agreement will be less restrictive than SNGMO's current financial covenant. Midco will be limited to ** _____ ** debt-to-capitalization, whereas SNGMO has a ** _____ ** debt-to-capitalization limit. Consequently, the consolidation of the three entities does allow for the potential to use a higher percentage of leverage in the capital structure. However, if CNG and AOG continue to issue debt at the operating company level, this will limit the amount of debt Midco can issue.

As previously indicated, Midco plans to retire all of SNGMO's current debt outstanding. After SNGMO's third-party debt is extinguished, SNGMO's balance sheet will imply that it is capitalized with 100% equity.²

Paragraph 8 at page 3 of SNGMO's Application states, in principal part, as follows:

. . . The principal advantage of the proposed financing is to provide funds to Midco that it can, in turn, provide to the Company and Midco's other subsidiaries. The terms of the long-term debt are more advantageous than the terms the Company can access under the Credit Agreement. This will, in turn, tend to result in a lower cost of service for the Company than would otherwise be the case.

Midco's debt is likely to have more favorable terms than SNGMO's debt as it relates to the following: (1) term to maturity, (2) the ability to receive a fixed interest rate, (3) the margin over LIBOR and (4) less restrictive financial covenants. However, because SNGMO would not have any debt on its balance sheet, Staff cannot affirm that SNGMO would have a lower cost of service under the proposed scenario. Staff and SNGMO had significant disagreements in SNGMO's last rate case, Case No. GR-2014-0086, regarding the appropriate capital structure to use to set SNGMO's rate of return. Staff argued for a more leveraged capital structure because in Staff's

² SNGMO's response to Staff Data Request No. 0006.

opinion, the Company's significant expansion in the Lake of the Ozarks limited SNGMO's debt capacity for its existing natural gas distribution systems. The Company argued for use of the actual capital structure, which reflected the limits debt investors placed on SNGMO's ability to use more leverage. Ultimately, the Commission authorized SNGMO's actual per books capital structure, which consisted of 57% equity. Typically, the greater the proportion of common equity in the capital structure, the higher the revenue requirement. This is due to the fact that equity typically costs more than debt within the same capital structure, especially after consideration of income taxes. In response to Staff Data Request No. 0016, the Company stated the following:

While Summit Natural Gas of Missouri, Inc. will likely not recommend a 100% common equity ratio in its next rate case, it would be premature for it to speculate about how it will determine a reasonable capital structure for its next rate case.

Because the Company indicates that the anticipated terms of the Midco financing will tend to result in a lower cost of service for SNGMO, Staff would expect SNGMO's cost of service to reflect such lower capital costs in its next rate case. Being that the lower costs of debt capital cannot be captured in SNGMO's cost of service unless debt is included in the capital structure, practically speaking, SNGMO would have to include some ratio of debt in its recommended capital structure for ratemaking purposes in order for its statement to be true that the Company will tend to have a lower cost of service. Staff's testimony in SNGMO's next rate case will specifically address this issue to allow the Commission to make a determination as to whether the Company's recommended rate of return ("ROR") reflects the anticipated capital cost savings.

I have been involved directly or indirectly on financial matters involving SNGMO/MGU since MGU's initial Application to acquire the Gallatin and Hamilton systems in Case No. GO-2005-0120. Pursuant to a condition in paragraph 16 of a Nonunanimous Stipulation And Agreement in Case No. GO-2005-0120, the pledging of MGU's (SNGMO's predecessor in interest) equity as collateral or security for holding company debt or any other subsidiary debt without MGU's obtaining Commission approval was prohibited. The intent of requiring SNGMO to seek Commission approval to allow its equity to be pledged for an affiliate's loan was to ensure that such financing would not be detrimental to SNGMO's ability to attract capital at reasonable costs. As explained earlier in Staff's recommendation, ** _____

**, which will cause a more leveraged capital structure at Midco than currently exists at SNGMO. If this additional leverage and its associated cost savings are reflected in SNGMO's recommended ROR in its next rate case, allowing SNGMO's equity to be pledged

as collateral may result in a benefit to SNGMO's ratepayers. Again, Staff's testimony in SNGMO's next rate case will specifically address this issue.

A Staff concern prompted by the proposed reorganization that results in a proposed condition is access to Summit's books, records and information. Under the proposed reorganization, Summit would become an indirect holding company. In response to a Staff Data Request regarding discovery, SNGMO responded that "[i]f the restructuring occurs, Summit will still provide Staff access to its information consistent with that it has previously provided to Staff in case proceedings involving SNGMO." In order to help ensure that the creation of an intermediate holding company does not result in less access to Staff's discovery requests for Summit information, Staff recommends a condition.

Recommendation:

Staff recommends that this Application be approved as not detrimental to the public interest with the following condition:

1. That Staff's access to Summit Utilities, Inc.'s books, records and information shall be no less after the creation of Midco than Staff's access before the creation of Midco.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of Summit)
Natural Gas of Missouri Inc. for Authority to) Case No. GO-2019-0216
Participate in a Corporate Restructuring)
which will result in the Taking and Holding)
of all of its Capital Stock by a Newly-)
Formed Subsidiary of Summit Utilities, Inc.)

AFFIDAVIT OF DAVID MURRAY

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

COMES NOW DAVID MURRAY and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing *Staff Recommendation in Memorandum form*; and that the same is true and correct according to his best knowledge and belief.

Further the Affiant sayeth not.



DAVID MURRAY

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 22nd day of

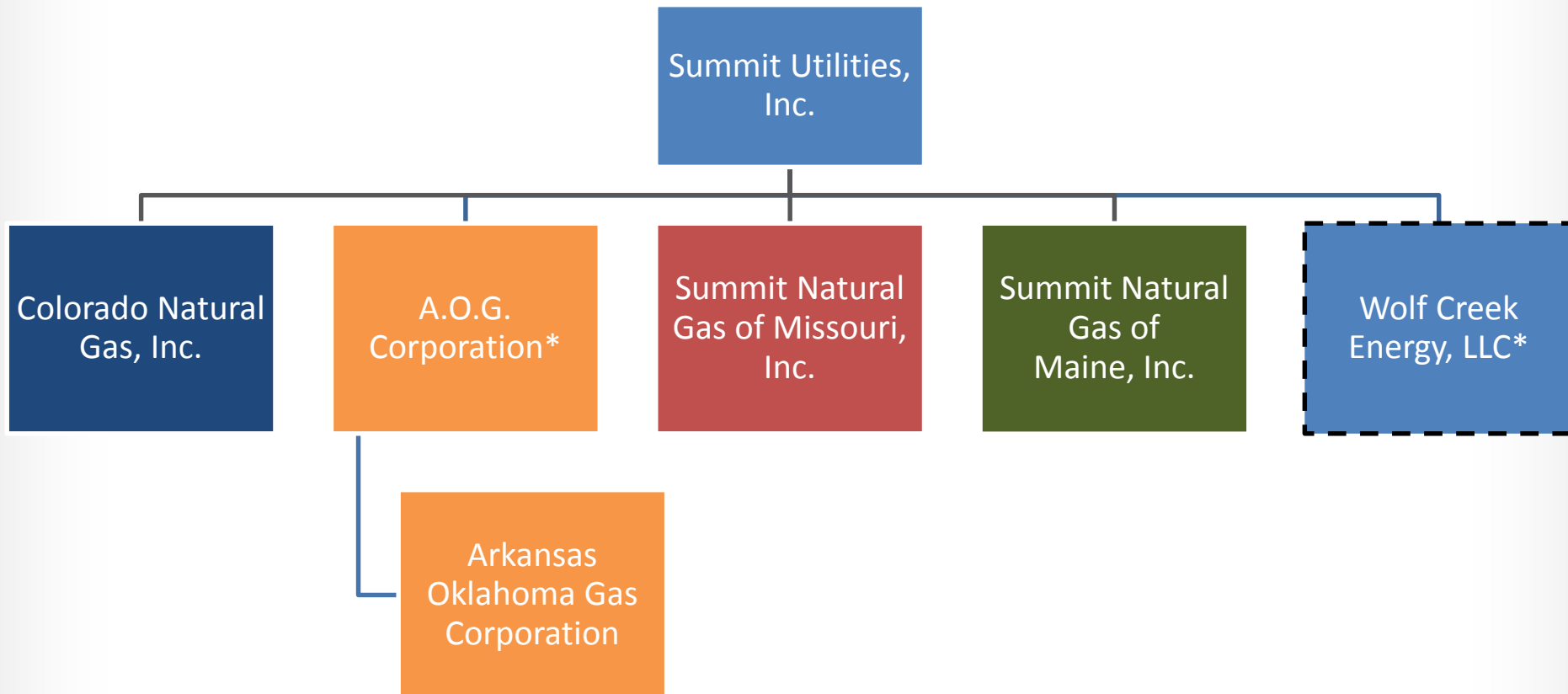
February 2019.

D. SUZIE MANKIN Notary Public - Notary Seal State of Missouri Commissioned for Cole County My Commission Expires: December 12, 2020 Commission Number: 12412070
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Notary Public

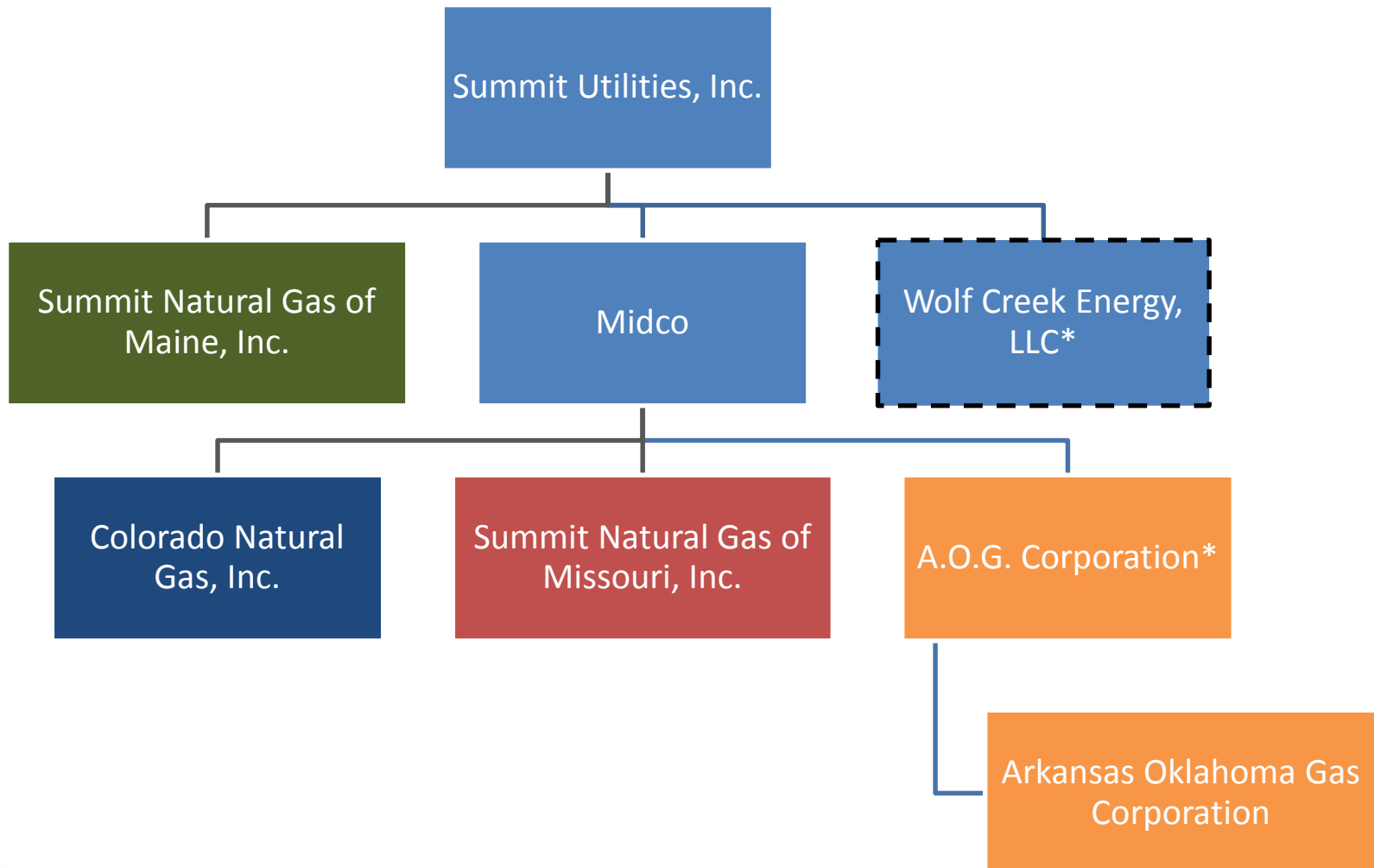
Current Corporate Structure



* Unregulated subsidiary

Schedule 1

Proposed Corporate Structure



* Unregulated subsidiary

Schedule 2