MEMORANDUM

TO: Missouri Public Service Commission Official Case File
Case No. GF-2007-0215, Southern Missouri Gas Company, L.P.

FROM: David Murray, Financial Analysis Department

/s/ David Murray 02/11/08 | **/s/ Lera Shemwell 02/11/08**
Project Coordinator / Date | General Counsel's Office / Date

SUBJECT: Staff Recommendation to approve with conditions the Second Amended Financing Application of Southern Missouri Gas Company, L.P. d/b/a Southern Missouri Natural Gas for authority to issue approximately $13.5 million in Equity Capital (initial application requested authority to issue $10 million in equity capital) and approximately $43 million in notes and other forms of indebtedness (initial application requested authority to issue $50 million in debt capital).

DATE: February 11, 2008

Southern Missouri Gas Company, L.P.

OVERVIEW:

1. (a) **Type of Issue:** Senior Secured Notes Issued by Southern Missouri Gas Company, L.P. and Equity through Membership Interests in Sendero SMGC GP Acquisition Company, LLC and Sendero SMGC Limited Acquisition Company, LLC.

   (b) **Amount:** Up to $45,000,000 of debt proceeds and up to $15,000,000 of equity proceeds.

   (c) **Rate:** The interest rate on the senior secured notes is anticipated to be 9.25 percent.

2. **Proposed Date of Transaction:** As soon as possible.

3. (a) **Statement of Purpose of the Transaction:** The Applicant proposes to apply the net proceeds from the senior secured long-term debt and equity for working capital, capital expenditures, and other lawful corporate purposes, including the proposed expansion of its service area to include Lebanon, Houston, Licking, Branson, Hollister, and Branson West, which were the subject of Case Nos. GA-2007-0212, GA-2007-0310 and GA-2007-0168.

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

   Yes _X_ No

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4. **Type of Transaction:** The Applicant proposes to receive debt and equity proceeds from the same capital provider, ** ____________________________ **, which is a private equity fund that invests in infrastructure related investments.

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 after the execution of the instruments.

___ (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 _X_ No

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)

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COMMENTS:

Company Background. Southern Missouri Gas Company, L.P. d/b/a Southern Missouri Natural Gas, a Missouri limited partnership, (SMNG or Company) owns and operates a natural gas transmission and distribution system located in southern Missouri which serves approximately 7,500 residential, commercial and industrial customers. SMNG is currently 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 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.

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. Attachment 1 to this recommendation is an organizational chart illustrating the current ownership structure of SMNG. Staff is not sure how the potential transaction identified in Paragraph 6 of the Second Amended Financing Application will impact the current organizational structure.

SMNG has represented to Staff that the only investment held by Sendero GP and Sendero LP is SMNG. However, the equity investors in Sendero GP and Sendero LP have investments in other enterprises through other affiliates.

SMNG's is currently in a very weak financial position. Based on representations made by SMNG in response to Staff Data Request No. 8, SMNG is in violation of its Fixed Charge Covenant ratio contained in its current credit agreement with GMAC. To Staff's knowledge, SMNG continues to be in violation of this covenant. Apparently, SMNG is in compliance with the other two financial ratio covenants due mainly to the amount of equity represented on SMNG's balance sheet. Although SMNG's 2006 year-end audited balance sheet indicates an equity balance of $28,313,293, Staff does not believe that this balance provides any insight to the economic net worth of SMNG. Staff suspects that the proposed issuer of the debt and equity capital does not give weight to the book value of equity either. However, if one were to accept the balance sheet at face value, one would conclude that SMNG has over 60% of equity in its capital structure, an erroneous conclusion.

The economic value of the equity is most appropriately determined by estimating the enterprise value of SMNG and deducting the amount of debt outstanding from this value. Staff believed it could provide the Commission with the most relevant estimate of the current economic value of the equity in SMNG by identifying the ** ____ ____ ** but SMNG refused to provide this information in response to Staff Data Request No. 23. Therefore, Staff estimated the value of the equity invested in SMNG by starting with a range of equity estimates based on Sendero's purchase price of SMNG in May 2005 of ** ____________ ** and deducting the initial amount of debt incurred in conjunction with the transaction of $13.50 million. This results in an initial equity interest of $1.55 million, which is very close to an amount indicated in a ** ____ ____. ** Another equity balance estimate that may have some relevance is a representation from SMNG in a Sendero partnership agreement provided in Case No. GM-2005-0136 of a total equity interest of ** _________ ** from the existing partners. However, because Staff is unaware of any capital contributions other than the original $1.55 million, it used the lower estimate for purposes of estimating SMNG's current equity balance. Staff estimated the current equity balance by estimating the net income/loss to the partners based on a lower depreciation expense (because of the estimated write-down of the plant balance to purchase price), adding this income (subtracting if it's a loss) to the estimated starting equity balance and adding any additional equity capital contributed.

Because Sendero purchased SMNG for approximately 33% of its historical book value, Staff simply reduced depreciation expense by 66% to arrive at an estimated net income since Sendero purchased SMNG. Staff's estimates of SMNG's income since May 2005 are as follows: June-December 2005 – loss of $446,900; 2006 – loss of $1,263,722; and January-September 2007 – loss of $938,817. This results in a cumulative net loss of $2,649,439 since Sendero's acquisition of SMNG. After deducting this amount from the initial equity contribution of $1.55 million, SMNG has a current equity balance of $-1,099,439.

Staff also determined the estimated amount of debt outstanding for certain periods since Sendero acquired SMNG to compare this to the estimated equity balance. In order to compare this to the amount of debt invested in SMNG over the same time, Staff evaluated the change in debt levels. Staff's estimates are as follows: June-December 2005 – $1,900,000; 2006 - $505,500; and January-September 2007 - $1,217,477. This results in a total increase in debt of $3,622,977. Please see Attachment 2 for the indicated changes in capital and the percentage of debt and equity capital for various periods since Sendero acquired SMNG. It is important to emphasize that although the attachment shows a negative equity balance, it is possible that the proposed investor may have estimated a positive value for its proposed acquisition because of its projections of future cash flow from current and proposed operations.

Issuance of Equity. Based on the opinions of counsel for SMNG and the Commission's General Counsel, SMNG does not need to request Commission authority to issue the equity that is identified in the application. According to the description of the equity capital and debt securities contained in Appendix B attached to the application, the issuer of the $13.5 million in equity will be Sendero GP and Sendero LP and the holder of the equity will be ** ____________________________ ____________ **. Apparently the issuing entities are not considered to be "gas corporations" under law since they only contain the partnership interests in the regulated "gas corporation," SMNG. In fact, Staff confirmed this to be SMNG's position during a conference call on January 11, 2008. It is Staff's understanding that the General Counsel's Office does not disagree with this position. Therefore, other than providing a description of the proposed financing transaction, Staff is not providing a recommendation on the funds raised by the equity issuance.

Issuance of Debt. The Second Amended Financing Application requests permission to issue approximately $43 million of senior secured debt. Because, SMNG had requested an approximate amount of debt financing, Staff requested SMNG to specify an upper limit on requested financing. SMNG indicated that it believed it would need no more than $45 million. Upon Staff's review of the proposed terms and conditions of this debt, Staff discovered the possibility of an additional $12 million for a Revolving Credit Facility [RCF] that would rank "pari passu" with the senior secured debt. Staff interpreted this as meaning that the RCF would also be secured by SMNG's assets, which would imply the need for Commission approval. After inquiring about this matter with SMNG's counsel, Staff was informed that SMNG does not plan on pursuing the RCF at this time. If it does so in the future and it needs to secure such funds with SMNG assets, then it will file for Commission approval to do so.

The debt proceeds proposed in the Second Amended Financing Application would come from the same private equity fund, ** ____________ ** that is proposing to be the holder of the equity. However, it is important to note that SMNG has not submitted any documentation that ** ____________ ** has given its commitment to provide the financing. The fact that ** ____________ ** is the proposed debt and equity investor is a unique situation that Staff attempted to explore in more detail through discovery and further research. Staff believes that this unique situation would be advantageous to SMNG if Staff received a commitment that this structure would remain in place after the closing of this transaction and based on a February 11, 2008 conference call with representatives from ** ____________ **, they were willing to provide this commitment. Staff's recommendation regarding this proposed transaction is based on its understanding of the potential motives of the investors for structuring the financing as proposed in the Second Amended Financing Application. Staff considers this situation unusual because if ** ____ ________________________________ **, then based on information provided by SMNG to date, ** ____________ ** will have a total financial interest in the Company of more than 99%. Staff's conference call on February 11, 2008 with representatives from ** ____________ ** confirmed that they do intend to be an active investor and because they are a private equity fund, their strategy is to take equity positions and not typically debt positions. They represented that the main reason for the creation of the debt instrument is because they were accommodating capital needs of SMNG because of difficulties in procuring reasonable third-party debt financing at this time. If they are able to procure more reasonable debt financing from a third-party in the future, then they will do so and seek Commission approval to issue this debt.

The use of financial leverage (i.e. debt) typically causes increased risk to the equity investors because equity holders are subordinate to the debt holders who have a fixed first claim on cash flow. This causes increased variability of the cash flow to the equity investors. However, this situation is different because under the proposed financing arrangement, the major equity investor in the proposed transaction will also hold the debt. This means the variability in returns will be evaluated against the total investment, which will be less variable than if ** ___________ ** only owned equity. If the total investment comes from the same private equity fund, the introduction of financial risk does not disadvantage its total investment. The only parties disadvantaged by introduction of a debt instrument are the partners, Sendero Capital Partners and Michael Lewis who will remain after the sale of ** ____________________________ **.

Another way ** ___________ ** could have accomplished its objective of having a priority claim on certain cash flows from SMNG would have been to revise the existing partnership agreement that exists between Sendero Capital Partners, CHx Missouri and Michael Lewis. Staff views the ** ___________ ** debt instrument much the same as the debt instruments that may be created by owners of small water and sewer operations. Even though the owners of these operations introduce a debt instrument, they won't require payments on the "debt" unless there are funds available. In fact, these instruments act more like preferred stock in that the security has a stated coupon/dividend rate and the owners of the company may treat these coupons/dividends as cumulative and only take distributions if the funds are available at some future date.

As a result of the peculiarities of this proposed financing transaction and the appearance that the debt instrument proposed is more like a different class of partnership interest, Staff does not believe that performing a quantitative analysis of SMNG's financial ratios provides meaningful insight into the potential effect the proposed debt instrument will have on the creditworthiness of SMNG. In fact, it is the peculiarities of the proposed structure of this financing that provide Staff reassurance about the intent of the capital provider, ** ___________ ** to provide safe and reliable service. In some cases, equity owners are not active in an utility's operations. In these circumstances, if the debt investor acquires ownership of the system due to a default, then safe and reliable service may become suspect due to the debt investors initial intent of only being a financial resource. Based on Staff's analysis of SMNG's representations in its Second Amended Financing Application, it appears that ** ___________ ** has every intent to be active in the ongoing operations of SMNG. In fact, Staff believes it would be prudent to condition the approval of the proposed financing on ** ___________ ** continuing to be the majority equity investor in SMNG's operations as long as it holds the proposed debt instrument. Staff's proposed conditions at the end of its recommendation address this matter. Another reason Staff believes that ** ___________ ** intends to be an active owner regardless of whether SMNG is able meet its debt service is because ** _______________ ____. ** For this reason, it appears that ** _____________ ** long-term strategy is to be more than a passive financial investor in natural gas distribution operations.

If Staff's conclusions are correct about ** _____________ ** intent to be active in its investment in SMNG, then the proposed transaction may actually benefit SMNG because it will eliminate the GMAC debt. It is Staff's understanding that because SMNG has not been able to meet all of the financial covenants contained in the GMAC credit agreement, GMAC could place SMNG in default and require accelerated payment on its debt investment. However, GMAC has not done so.

Staff does not believe the proposed financing structure will be the primary factor affecting the Company's ability to attract capital in the future. Staff believes that it is the success, or lack thereof, of SMNG's expansion proposals that will determine its ability to attract capital in the future. For example, if the cost of expansion significantly exceeds SMNG's estimates, it may have greater difficulty attracting capital. However, Staff believes it is very important, as it has been in other cases in which natural gas systems have been built under similar circumstances, that the Commission's possible approval of the proposed financing does not constitute an endorsement or approval of any specific cost of capital effects caused by this or any subsequent financing. This is especially true in this case because Staff has been unable to determine and, therefore, does not have confidence that the terms and conditions negotiated for the proposed debt instrument were truly arms length. Staff and the Commission should review the circumstances of this Company at the time of a rate case or complaint case and decide a prudent cost of capital at that time. If the Company's actual cost of capital is deemed to be imprudent because of financing decisions made by the Company, then Staff will adjust actual capital costs as necessary, as it has done in situations involving Aquila's cost of capital.

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 believes that the Company should file the necessary journal entries/information reflecting the utilization of the debt issuance proceeds to determine applicability of the fee schedule. The Company received approval in Case Nos. GA-2007-0212, GA-2007-0310, pending financing acceptable to the Commission. It was the Company's decision to delay the start of these projects by its desire to include its proposed expansion in Case No. GA-2007-0168, which recently received conditional Commission approval, in this financing case. Staff had proposed that these financings be done separately so the Company could accomplish its important goal of providing natural gas to Lebanon, Houston and Licking as soon as possible. However, the Company chose not to proceed in this manner and included additional expansion proposals in its amended financing request.

RECOMMENDED CONDITIONS:

Staff recommends that this Application for financing 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 all final terms and conditions of the proposed financing, including, but not limited to, the aggregate proceeds received, price information, and estimated expenses.

3. That the funds authorized pursuant to the debt instrument shall only be used for capital expenditures related to the proposed expansion of Lebanon, Houston, Licking, Hollister, Branson, Branson West and the existing SMNG natural gas distribution system and the funds shall not be used for the purposes of paying operating expenses.

4. That the Company file with the Commission any information concerning deviations from their stated use of the funds from the issuance(s) that would materially change the pro forma financial statements.

5. That the debt and equity investor shall be ** ____________________ ** as represented in the Second Amended Financing Application.

6. ** ____________________ ** agrees and warrants that as long as ** ____________________ ** is the noteholder of the debt instrument proposed in the Second Amended Financing Application, it will also continue to hold the majority equity interest. If the debt instrument proposed in the Second Amended Financing Application should be refinanced at some time in the future, SMNG will request Commission approval to do so.

7. That the approval is only for the proposed $45 million of senior secured debt and not the $12 million Revolving Credit Facility identified in the terms and conditions of the senior secured debt.

8. That the length of authority for this approval is for sixteen months following the effective date of the Commission's order approving the $45 million of senior secured debt.

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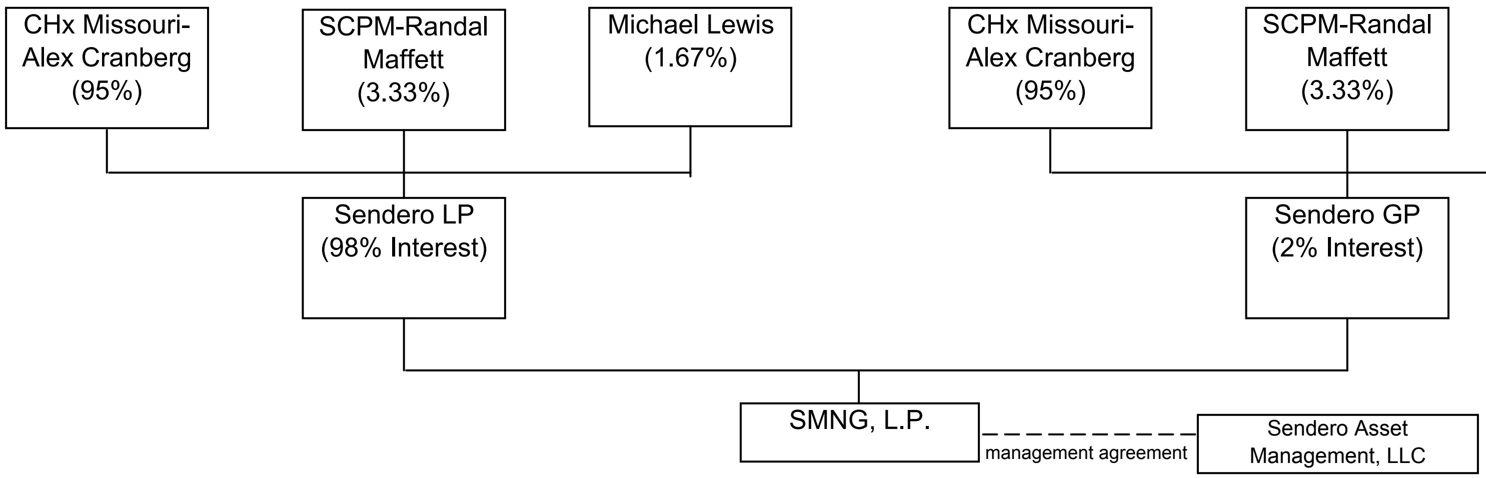
9. That SMNG will not seek an increased cost of capital as a result of financing decisions that are considered to be imprudent. SMNG understands that the Commission's authorization of this financing proposal is not an endorsement of the proposal for purposes of setting the rate of return in future rate or complaint cases.

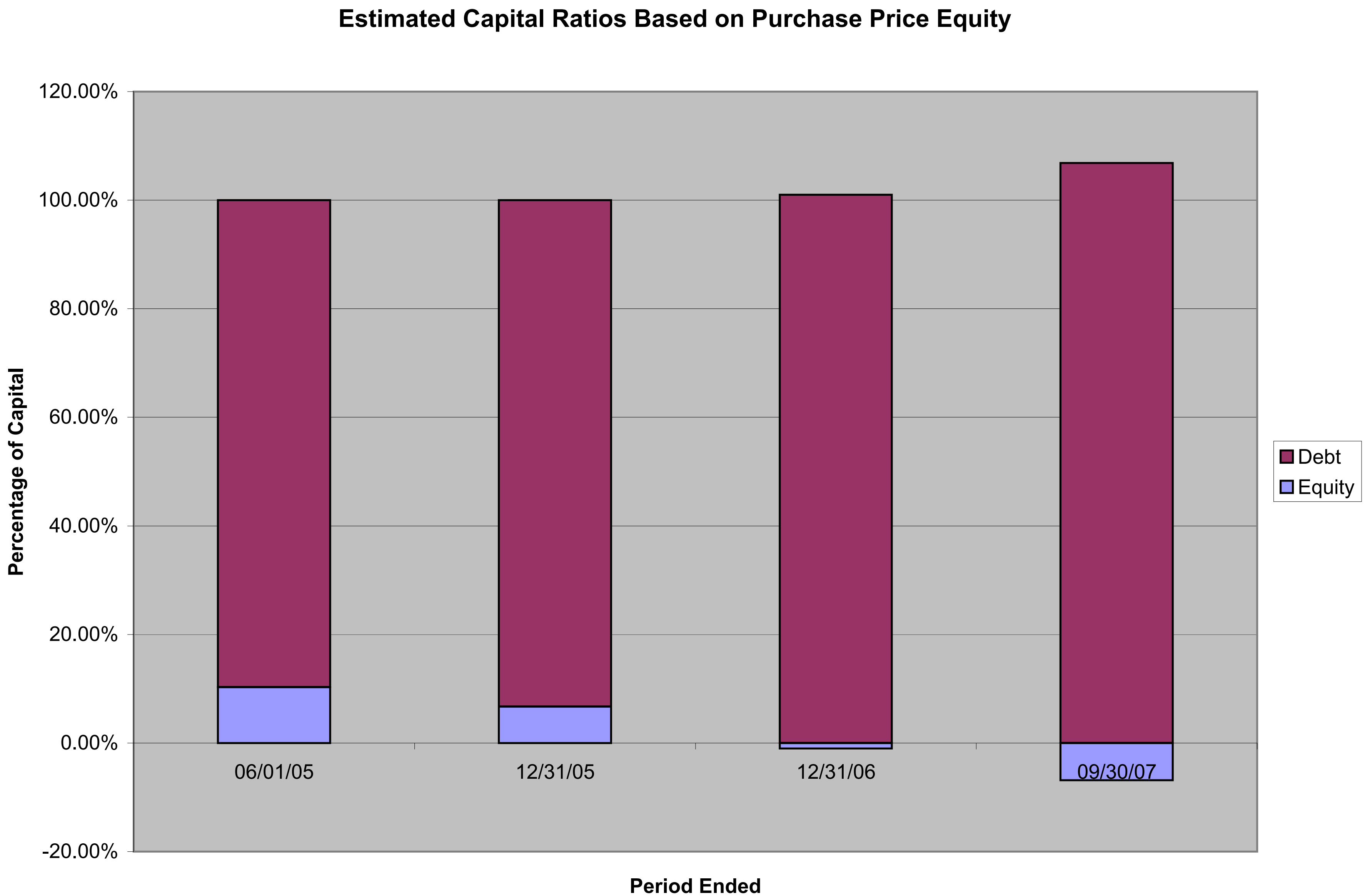
SOUTHERN MISSOURI GAS COMPANY, L.P.
CASE NO. GF-2007-0215

OWNERSHIP STRUCTURE OF SOUTHERN MISSOURI GAS, L.P.



Attachment 1

Attachment 1



Attachment 2

Attachment 2

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the matter of the Application of Southern	)	
Missouri Gas Company, L.P., d/b/a Southern	)	Case No. GF-2007-0215
Missouri Natural Gas, for Authority to Issue	)	
approximately $10 Million in Equity Capital	)	
and approximately $50 Million In Notes and	)	
Other Forms of Indebtedness	)	

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

David Murray

Subscribed and sworn to before me this 11th day of February, 2008.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
County of Cole
My Commission Exp. 07/01/2008

D Suzie Mankin

Notary Public