

MEMORANDUM

TO: Missouri Public Service Commission Official Case File
Case No. GF-2011-0352, Southern Missouri Gas Company, L.P. d/b/a Southern Missouri Natural Gas

FROM: Zephania Marevangeo, Financial Analysis Department
/s/ Zephania Marevangeo 06/01/11 /s/ Lera Shemwell 06/01/11
Financial Analysis Department Staff Counsel's Office

SUBJECT: Staff Recommendation to approve the Application of Southern Missouri Gas Company, L.P. d/b/a Southern Missouri Natural Gas (SMNG or Applicant) for authority to issue up to and including \$28,000,000 of short-term indebtedness in one or more transactions and to, among other things, execute and deliver a mortgage and security agreement to secure said indebtedness.

DATE: May 20, 2011

Southern Missouri Gas Company, L.P

1. (a) **Type of Issue:** Secured short-term term loan.
(b) **Amount:** Up to \$28,000,000.
(c) **Rate:** The interest rate could vary with funds available in one or more tranches but is expected to be approximately 3.75%
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 to capital expenditures, the purchase of gas, payment of IIF SMNG Investment LLC debt and other lawful purchases.
(b) **From a financial perspective, does Staff deem this purpose reasonable?**
Yes X No
4. **Type of Transaction:** The Applicant proposes to receive secured short-term debt proceeds from CoBank in the form of a commercial term loan.
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 commitment to provide the terms and conditions of the instruments when they are available has been 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 ☒ No
7. **Capital expenditure schedule reviewed:**
Yes ☒ No
8. **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:

Southern Missouri Gas Company, L.P. d/b/a Southern Missouri Natural Gas (the Applicant), a Missouri limited partnership, owns and operates a natural gas transmission and distribution system located in southern Missouri which serves approximately 9,000 residential, commercial and industrial customers.

The Applicant has filed an Application seeking authority to issue up to \$28,000,000 in aggregate principal amount of secured short-term debt before its proposed merger with Missouri Gas Utility (“MGU”), which is the subject of Case No. GM-2011-0354. Subsequent to the anticipated completion of the merger, MGU will become the surviving entity. The Applicant and MGU are both wholly-owned by IIF through IIF CNG Investment LLC, IIF SMNG Investment LLC and IIF SMNG Investment II LLC (collectively “IIF”).

Issuance of Debt. The proceeds from the secured short-term debt will be received from CoBank – a cooperative bank which provides loans, lease, export financing and other financing services to agribusinesses and rural power, water and communications across rural America.

The interest rate charged could vary with funds available in one or more tranches but is expected to be approximately 3.75% for the 1-year term of the loan.

The net debt proceeds will be applied to capital expenditures (approximately \$11.3 million), the purchase of gas (approximately \$1.7 million), refunding of IIF invested capital (approximately \$15 million) and other lawful purchases. The capital expenditures include short mainline extensions and service line extensions to customers already in SMNG territories. The purchased gas will be used to fill the storage in preparation for the 2011-2012 winter heating season.

While Staff would typically be concerned about a proposal to issue short-term debt to fund long-term capital investment, SMNG represented to Staff that it is requesting authority to issue short-term debt rather than long-term debt because of its plan to recapitalize if its proposed merger with MGU is completed. In response to Data Request No. 0007, SMNG indicated that in the event that the proposed merger is not finalized, it plans to request Commission Authority to refinance the short-term debt with long-term debt.

Leverage. Considering the fact that SMNG is currently completely capitalized by IIF, raising \$28 million of 3rd party debt for purposes of supporting SMNG's operations appears to be reasonable. Although SMNG plans to merge with MGU, in the event that this merger is not successful, SMNG's 3rd party leverage on a stand-alone basis is within a reasonable level. Based on the adjusted total capitalization provided by MGU witness Timothy R. Johnston as Highly Confidential Schedule TRJ-1 attached to his Direct Testimony in Case No. GM-2011-0354, this 3rd party debt is less than 30% of total capitalization. Additionally, using SMNG's projected cash flows and adjusting the Funds From Operations (FFO) to Total Debt Ratio (FFO/debt)¹ to only consider 3rd party debt, SMNG's FFO/debt ratio is expected to be in excess of 20%, which is within the range of the benchmarks of a BB to BBB rating for a company with a business risk profile of "strong."

Other Comments. Although Staff is recommending approval of the Applicant's application for financing authority, Staff's analysis relied on the representations made by the Applicant in the application and the Applicant's responses to Staff data requests. Specifically, Staff's financial ratio analysis relied on the Applicant's assumptions underlying the Applicant's projected financial statements. SMNG's ability to generate enough cash flows to satisfy its projected financial ratios, obligations and benchmarks relies heavily on the projected customer base growth and increase in demand for gas. Consequently, the probability that the projected financial statements will reflect reality is not certain. However, it is Staff's hope that IIF's business strategy will yield the projected results.

¹ FFO to Total Debt is one of the key financial ratios used by Standard & Poor's to assess the ability of companies to carry a certain amount of debt on their books to maintain certain ratings based on a given business risk profile.

Since IIF's acquisition of ownership interest in SMNG, it has invested significant amounts of capital in the system mainly through continued expansion. SMNG continues to be much less leveraged than it was before IIF acquired ownership interest and has represented to Staff and demonstrated through its ongoing investment that it is committed to continued investment in this system and that of the MGU system.

As is typical in any financing Application, Staff recommends that the Commission make it clear in its Order that its approval of this financing does not constitute an endorsement or approval of SMNG's capital structure or cost of capital for rate making purposes.

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 files 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 IIF SMNG Investment LLC and IIF SMNG Investment II LLC shall continue to be the majority equity investor until such time that IIF SMNG Investment LLC is no longer a noteholder of SMNG debt.
4. 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.

BEFORE THE PUBLIC SERVICE COMMISSION

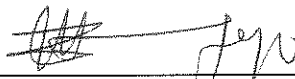
OF THE STATE OF MISSOURI

In the Matter of the Application of)	
Southern Missouri Gas Company L.P.)	Case No. GF-2011-0352
d/b/a Southern Missouri Natural Gas for)	
Authority to Enter Into Certain Debt)	
Instruments and to Issue Up to and)	
Including \$28,000,000 of Short-term)	
Indebtedness, in One or More)	
Transactions, and to, Among Other Things)	
Execute and Deliver a Mortgage and)	
Security Agreement to Secure Said)	
Indebtedness.)	

AFFIDAVIT OF ZEPHANIA MAREVANGEPO

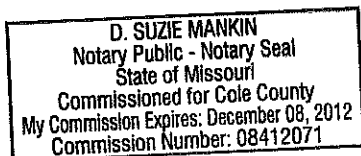
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)


Zephania Marevangepo, 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.



Zephania Marevangepo
Utility Regulatory Auditor III
Financial Analysis Department

Subscribed and sworn to before me this 15th day of June, 2011.





Notary Public