

BEFORE THE PUBLIC SERVICE COMMISSION OF WYOMING

IN THE MATTER OF THE JOINT)
APPLICATION OF KINDER MORGAN, INC.,)
SOURCE GAS DISTRIBUTION LLC, KM)
RETAIL UTILITY HOLDCO LLC, KNIGHT)
HOLDCO LLC, AND KNIGHT ACQUISITION)
CO. FOR APPROVAL OF A)
REORGANIZATION PURSUANT TO WHICH)
KINDER, INC. WILL BECOME A PRIVATELY)
HELD COMPANY AND FOR APPROVAL OF)
TRANSFER OF UTILITY ASSETS AND)
CERTIFICATE AUTHORITY FROM KINDER)
MORGAN, INC., TO SOURCE GAS)
DISTRIBUTION LLC, AS A WHOLLY OWNED)
INDIRECT SUBSIDIARY OF KINDER)
MORGAN, INC.)

Docket No. 30022-85-GA-06

Record No. 10813

PRE-FILED DIRECT TESTIMONY OF

Denise Kay Parrish

On Behalf of the Office of Consumer Advocate

Filed February 12, 2007
Hearing February 28, 2007

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Denise Kay Parrish and my business address is 2515 Warren Avenue, Suite 304, Cheyenne, Wyoming 82002.

Q. WHAT IS YOUR OCCUPATION?

A. I am currently the Deputy Administrator of the Wyoming Office of Consumer Advocate (OCA). In this position, I review and provide input into the recommendations made by the OCA. I review utility applications filed with the Wyoming Public Service Commission (Commission) and provide advice to the Administrator regarding the involvement the OCA should have, if any, in the various cases. I review applications, perform analyses and provide recommendations to the Commission relative to various utility matters, including revenue requirements, tariff language, competitive issues, rules and regulations, and other items. I write and issue press releases, perform special studies, as well as provide information and research to customers, the legislature, the OCA Administrator, and others. I do other assignments and tasks, as needed and as assigned by the OCA Administrator.

Q. WHAT IS YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND?

A. In 1976, I graduated from Michigan State University with a Bachelor's degree in Accounting. I have spent nearly thirty years as a regulator of public utilities, having been on the staff of four state utility regulatory commissions and two consumer advocate entities. More than fifteen of these years have been spent at the Wyoming Public Service Commission.

I have taken classes related to various aspects of public utility regulation, including income taxes, regulatory accounting, capital recovery, cost-of-service, rate design, revenue requirements, separations and allocations, and other specialized topics. I have taught classes on issues of accounting standards,

general ratemaking principles, affiliate transactions, regulatory accounting, financial reporting, and other specialized topics to regulatory professionals.

Since 2002, I have been an instructor at the Michigan State University Institute of Public Utilities (CAMP NARUC). I have also worked with the Nigerian Communications Commission on regulatory accounting and reporting matters and have done work for the International Telecommunications Union as a seminar leader. Furthermore, I have participated as a presenter at several meetings of the Tariff and Pricing Committee of the Energy Regulators Regional Association (ERRA).

I am the past chair and a current member of the National Association of Regulatory Utility Commissioners' Staff Subcommittee on Accounting and Finance. I am a member of the NARUC Staff Subcommittee on International Relations. I am listed in the current edition of Who's Who of American Women. I am currently a member of the National Association of State Utility Consumer Advocate's (NASUCA) Tax and Accounting Committee. Finally, I am a member of the staff of the Federal-State Joint Board on Universal Service.

Q. DO YOU HAVE EXPERIENCE AS AN EXPERT WITNESS?

A. Yes. I have testified more than one hundred twenty-five times as an expert witness. I have testified before the Michigan Public Service Commission, the Colorado Public Utilities Commission, the Colorado District Court, the Arizona Corporations Commission, the Wyoming Public Service Commission, and the Wyoming Legislature Joint Corporations Committee. I have provided testimony before an en banc hearing of the Federal State Joint Board on Universal Service about potential changes to the federal high cost fund. I also recently testified before the Federal Energy Regulatory Commission at a technical conference about cash management and affiliated transaction issues. I have testified in telecommunications, water, wastewater, electric, and natural gas cases. The subjects upon which I have testified include revenue requirements, rate design,

cost-of-capital, nuclear decommissioning, accounting deferrals, adjustment mechanisms, income taxes, capital recovery, universal service funding, and other specialized topics.

Q. WHO DO YOU REPRESENT IN THIS PROCEEDING?

A. As a member of the Office of Consumer Advocate, I represent the interests of Wyoming citizens and all classes of utility customers in this public utility matter, as required by W.S. § 37-2-401. It is neither my intent nor my charge to represent the position of any individual, group, municipality, or corporation.

Q. WHAT COURSE OF ACTION IS AVAILABLE TO INDIVIDUAL CONSUMERS OR OTHER INTERESTED PARTIES IF THEY WISH TO PURSUE ISSUES NOT ADDRESSED BY THE OFFICE OF CONSUMER ADVOCATE, OR TAKE A DIFFERENT POSITION FROM THE OFFICE OF CONSUMER ADVOCATE?

A. Consumers and other parties may intervene in the proceedings and raise additional issues not addressed by the Office of Consumer Advocate, and may take different positions than those presented by the OCA. Consumers may also present written or oral comments at the hearing, which then become part of the record in the case and are available to the Commission as it makes its decision on any particular proposal or suggested change. The OCA encourages the participation of the public and all interested parties in cases before the Commission.

Q. ARE YOU SPONSORING ANY EXHIBITS OR SCHEDULES IN THIS PROCEEDING?

A. Yes, I am. OCA Exhibit DKP-1 is a copy of a NARUC white paper on ring fencing that will be cited later in my testimony. Additionally, throughout much of the remainder of my testimony, I will refer to provisions found in the Stipulation and Agreement filed by the Joint Applicants and the OCA on February 9, 2007. Since this was provided earlier, I have chosen not to burden the record by

providing it again. However, it will be a useful document to access as I describe its terms and conditions.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to describe the concerns of the OCA regarding: (a) the proposed reorganization of Kinder Morgan in which it will become a privately held company, and (b) the proposed corporate restructuring in which Kinder Morgan's Wyoming retail distribution operations would be transferred to Source Gas Distribution. The privatization of Kinder Morgan is often referred to as the management buy-out (MBO). Additionally, my testimony explains how the Stipulation and Agreement that the OCA has entered into with the Joint Applicants mitigates or eliminates those concerns.

My testimony is being presented in conjunction with the testimony of Mr. Bryce Freeman. Our combined testimonies constitute the OCA's position in this matter.

Q. BEFORE DESCRIBING YOUR CONCERNS, PLEASE PROVIDE AN OVERVIEW OF THE APPLICATION AND THE ACTIONS THE COMMISSION IS BEING ASKED TO APPROVE.

A. In this application, filed October 3, 2006, Kinder Morgan, Inc. (Kinder Morgan), Source Gas Distribution, LLC (Source Gas Distribution), Kinder Morgan Retail Utility Holdco LLC (Kinder Morgan Holdco), Knight Holdco LLC (Knight Holdco), and Knight Acquisition Co. (Knight Acquisition) are the Joint Applicants. They are collectively asking for approval of a reorganization, a transfer of assets, and a transfer of certificate of public convenience and necessity.

Essentially, Kinder Morgan is seeking permission to become a private company, where its equity is no longer publicly traded, but instead, is held by Knight Holdco. Knight Holdco, in turn, will be owned by a limited number of equity investors, including many of the members of Kinder Morgan management who are rolling over their equity as part of the transaction. As a private company,

certain requirements that are applicable to public companies are eliminated, such as some of the Securities and Exchange Commission reporting requirements. This privatization would be accomplished by having Knight Holdco buy out the publicly traded shares, at a premium. The publicly traded shares of stock would then be retired, and the equity in Kinder Morgan would be held solely by Knight Holdco.

The transaction would establish a new, separate holding company as part of the Kinder Morgan family in order to separate the retail distribution assets from the remaining portion of the business. Under the management buy-out, the entity established to hold the retail utility company is K M Retail Utility Holdco.

The transaction also creates a subsidiary company known as Source Gas Distribution. This will be a distinct entity to own and operate the retail, distribution utility assets. The certificates of public convenience and necessity, assets and liabilities associated with the utility business will be transferred to this entity, and it will become the public utility operating company who provides natural gas distribution service to Wyoming customers.

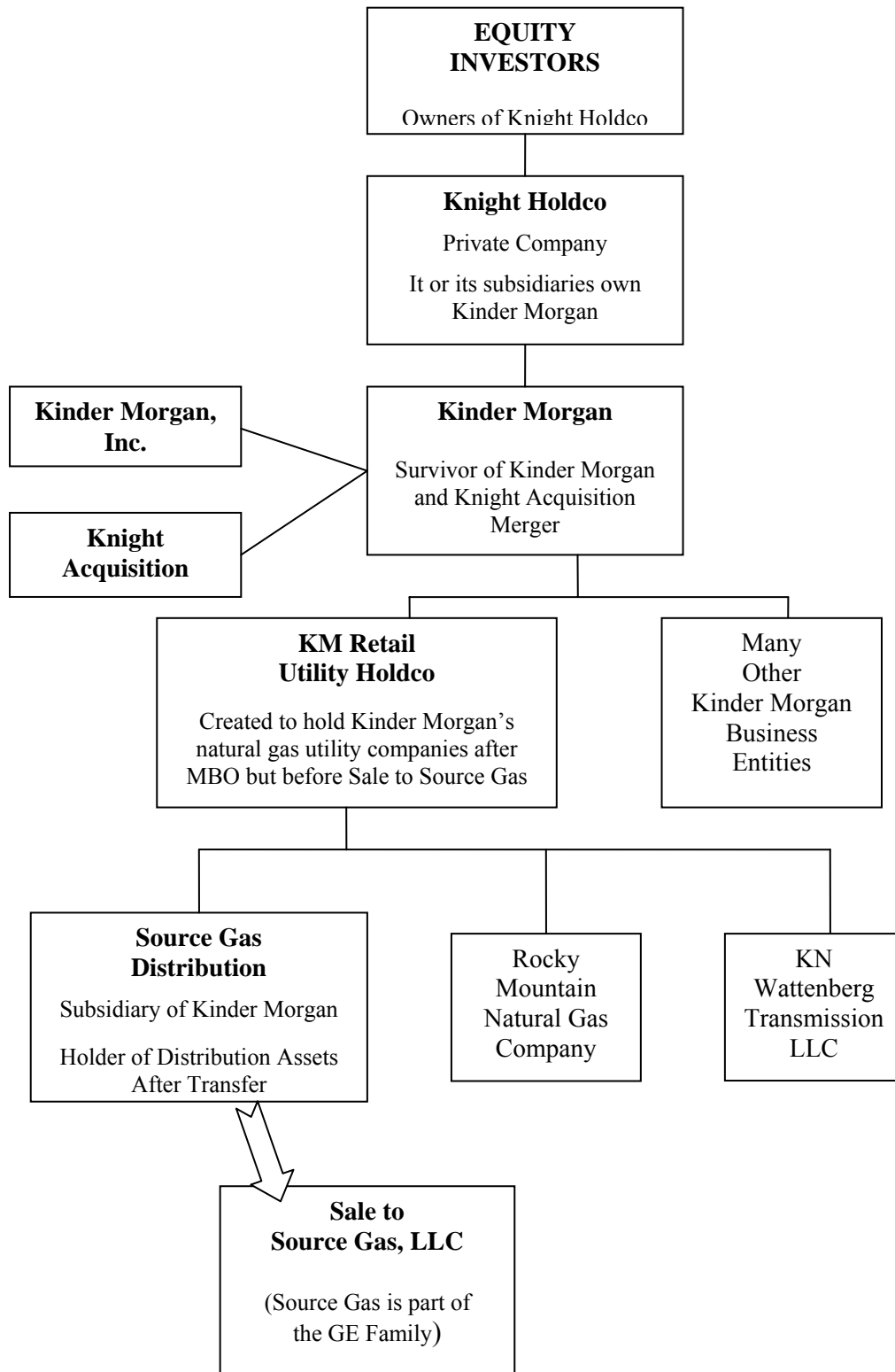
If approved in a companion application (Docket No. 30022-84-GA-06), Kinder Morgan's ownership interest in Source Gas Distribution will be transferred to Source Gas LLC. This would change the control of Source Gas Distribution and its distribution utility assets to Source Gas LLC, a member of the GE family of companies. If this were to occur, Kinder Morgan would no longer have any direct involvement in the control, ownership or operations of the Wyoming retail distribution assets.

The Commission has been given the authority to approve (or not) the proposed reorganizations involving at least one change in control. This would be the change from Kinder Morgan's control, to the control by Knight Holdco, and if the companion docket is approved, to the control by a member of the GE family of

companies. The authority of the Commission in regard to reorganizations is more fully described below.

The Commission must also approve a transfer of utility assets before the transaction is finalized. This would be the transfer of assets from Kinder Morgan, Inc., where the assets sit today, to Source Gas Distribution. Similarly, the Commission is being asked to approve the transfer of the certificate of public convenience and necessity. The statutes and rules that provide the authorities under which the Commission would make such decisions are also spelled out below.

I have attempted to capture the essence of the request in the diagram below:



Q. HOW DOES THIS APPLICATION RELATE TO THE COMPANION REQUEST IN DOCKET NO. 30022-84-GA-06?

A. This docket covers the management buy-out portion of the discussion. So, in reference to the schematic above, it would address all of the changes in ownership and the internal reorganization of Kinder Morgan, including the transfer of the certificate to Source Gas Distribution. The companion application addresses the sale of Kinder Morgan's ownership in the distribution assets to Source Gas LLC (a member of the GE family of companies). It also separately requests the transfer of the assets and certificate to Source Gas Distribution, as if the management buy-out application did not exist. In other words, each application was filed to stand completely on its own, without the other, as far as restructuring the organization so that the retail distribution assets and operational management end up in Source Gas Distribution.

There is one primary difference between the two applications in terms of ownership. If only the management buy-out application were to be granted, the assets found in Source Gas Distribution would remain part of the Kinder Morgan family and be owned by a private company. Alternatively, if the companion application – often referred to as the sale to GE (as a shorthand reference) – were the only one of the two applications to be approved, the assets and certificate would still be housed in the Source Gas Distribution entity, but would be owned by GE affiliated entities.

Q. ARE THESE INTENDED TO BE COMPETING APPLICATIONS, WHERE TWO SETS OF BUYERS WANT THE SAME ASSETS AND THE COMMISSION MUST CHOOSE THE WINNER?

A. No. While it would be easy to view the applications that way, that is not the intention. Instead, it is the hope and desire of all the parties – in both applications – that ultimately the purchase of the assets by the GE family of companies is approved. That is also the strong desire of the OCA. As explained in Mr. Freeman's testimony, we do not see the same public interest benefits coming from

the MBO on a stand alone basis, as we do from approval of the sale to GE. As Mr. Freeman strongly recommends, the MBO should not be approved on a stand-alone basis, but should only be granted in conjunction with the approval of the purchase by GE.

Q. IF ALL THE PARTIES AGREE THAT THE BEST COURSE OF ACTION IS FOR GE TO PURCHASE THE CURRENT KINDER MORGAN RETAIL DISTRIBUTION ASSETS, WHY IS THE MBO PROCEEDING NECESSARY AT ALL?

A. The management buy-out application was driven by a matter of timing. Kinder Morgan is anxious to accomplish the process of taking the company private, since the financial market and financial analysts continue to downgrade the current debt ratings, given Kinder Morgan's highly leveraged position. It was unclear, at the time of the applications, which of the two applications would be approved first, if at all. This concern about the timing of the approvals is expressed on page 9 of the application:

While both transactions are expected to occur, the timing and closing of each transaction are unknown and uncertain at this point. Therefore, regulatory approval is being requested for both transactions from each state commission (Colorado, Nebraska, and Wyoming) as well as from other governmental authorities. If the GE acquisition were to receive all necessary approvals and all conditions were met such that its closing were to occur first, then Commission approval of this Application, if not already obtained, would become unnecessary. On the other hand, if the Buy-Out Transaction were to receive all necessary approvals and all conditions were met such that its closing were to occur first, the first step of transferring Kinder Morgan's gas distribution assets to a subsidiary would have been approved, and the Commission would then need only proceed to approve the GE acquisition of that subsidiary, Source Gas Distribution.

I also view the MBO as Kinder Morgan's back-up plan for addressing its capital market difficulties, if the companion applications were not to be approved by this Commission, or some other regulatory body. If the MBO and associated corporate restructuring were accomplished, setting out the distribution operations

into its own entity, the corporate structure is ready-made for another buyer to make an offer on the distribution portion of the business, if the GE deal was not consummated.

Q. WHAT ARE THE WYOMING STATUTES THAT GOVERN THE COMMISSION'S REVIEW OF THE PROPOSED TRANSACTION?

A. W.S. § 37-1-104 specifically addresses the Commission's review of utility reorganizations:

(a) No reorganization of a public utility shall take place without prior approval by the public service commission. The commission shall not approve any proposed reorganization if the commission finds, after public notice and opportunity for public hearing, that the reorganization will adversely affect the utility's ability to serve the public.

(b) For purposes of this section, "reorganization" means any transaction which, regardless of the means by which it is accomplished, results in a change in the ownership of a majority of the voting capital stock of a public utility, or the ownership or control of any entity which owns or controls a majority of the voting capital stock of a public utility. "Reorganization" as used in this section shall not include a mortgage or pledge transaction entered into to secure a bona fide borrowing by the party granting the mortgage or making the pledge.

This statute directly relates to the reorganization portion of the application and indicates that the standard is whether *the reorganization will adversely affect the utility's ability to serve the public*. In the numerous mergers that have been before the Commission in the last decade, the Commission has examined concerns about the ability to serve on a broad, rather than narrow, basis.

For example, in the Cheyenne Light, Fuel and Power Dockets 20003-EA-04-75 and 30005-EA-04-97 (the cases in which Black Hills Corporation became the owner of Cheyenne Light), the Commission found, at paragraph 63:

Our general legal standard in this case is that we must uphold the public interest, and desires of the utility are secondary to the public interest. *Mountain Fuel Supply Company v. Public Service Commission*, 662 P.2d 878 (Wyo. 1983).

In this proceeding, the OCA has taken a broad view of what may constitute an *adverse ability to serve the public*, and of what constitutes *the public interest*.

Q. ARE THERE ANY OTHER STATUTES THAT MIGHT BE IMPORTANT TO CONSIDER WHEN EXAMINING THIS MATTER?

A. Yes. Part of the request in this case is to transfer Kinder Morgan's certificate of convenience and necessity to Source Gas Distribution. The relevant statute, W.S. § 37-2-205, does not speak to specifics of how to obtain a certificate, whether by transfer or other means, but does set forth, at subsection (b) that

No public utility shall henceforth exercise any right or privilege or obtain a franchise or permit to exercise such right or privilege from a municipality or county, without having first obtained from the commission a certificate that public convenience and necessity require the exercise of such right and privilege...

Subsection (c) describes some of the requirements for obtaining such a certificate:

Before any certificate may issue, under this section, a certified copy of its articles of incorporation or charter, if the application be a corporation, shall be filed in the office of the commission. The commission shall have power, after hearing involving the financial ability and good faith of the applicant and the necessity of additional service in the community, to issue said certificate, as prayed for, or to refuse to issue the same, or to issue to it for the construction of a portion only of the contemplated line, plant, or system, or of a portion only, of the contemplated line, plant, system or extension thereof, or for the partial exercise only of said right or privilege, and may attach to the exercise of the rights granted by said certificate such terms and conditions as in its judgment the public convenience and necessity may require.

In other words, the Commission has a great deal of discretion to grant or not grant the transfer (or reissue) the certificate to Source Gas Distribution. The Commission also has a great deal of discretion to attach terms and conditions to the transfer of the certificate. We suggest that that discretion should be driven by what is in the overall public interest.

Q. ARE THERE ALSO COMMISSION RULES THAT ARE APPLICABLE TO THE REQUEST DESCRIBED IN THE JOINT APPLICATION?

A. Yes. Section 204 of the Commission’s Procedural Rules and Special Regulations sets forth the requirements related to *Applications for Certificates of Public Convenience and Necessity*. Primarily, the rule contains a list of the specific items that a certificate applicant is required to provide in the application. It does not, however, remove the Commission’s discretion relative to approval, modification, or disapproval of the certificate application. An applicant could provide the entire list of information, and the Commission could still place conditions on the approval of the certificate.

Section 208 of the rules contains the requirements related to an *Application for Discontinuance or Abandonment of Service for Discontinuance of the Operation or for Abandonment, Transfer, Lease, etc. of Utility Plant or Facilities*. The portion of the rule most relevant to this proceeding is that a utility seeking to transfer or sell utility plant or facilities “shall prior to such action obtain authority therefore from the Commission by filing an application substantially in the form of Section 901(d) (Form 4) of Chapter IX.” Additionally, Section 208 requires the utility to include in its application “studies of past, present and prospective customer use of the subject service, plant or facility as is necessary to support the application.”

Sections 204 and 209 both contain a filing requirement of “the financial condition of the applicant.” Section 202(a) provides a lengthy list of the information that should be provided under the *financial condition* requirement.

Q. IF THE OCA IS ONLY RECOMMENDING THAT THE MBO BE APPROVED IN CONJUNCTION WITH THE APPROVAL OF THE COMPANION APPLICATION (I.E., THE SALE TO GE), WHY IS IT NECESSARY TO PLACE A NUMBER OF CONDITIONS AND LIMITATIONS ON THE TRANSACTION?

- A. The MBO transaction, as proposed in the application, is not in the public interest, even if it is only in effect for a short period of time while the sale to GE is finalized and closed. There are too many concerns and uncertainties regarding the impact that the proposed arrangement will have on Wyoming retail customers and Source Gas Distribution's ability to be a reasonably priced, well financed, long-term operation. However, with the conditions contained in the Stipulation and Agreement, our concerns are greatly mitigated or eliminated.

The proposed MBO transaction should only be approved if the terms and conditions found in the Stipulation are incorporated into the approval package.

Q. PLEASE DESCRIBE YOUR FIRST CONCERN.

- A. The OCA is concerned that without some *ring fencing* provisions, there will be inadequate separation between the regulated and non-regulated operations of the new owners, potentially putting the regulated assets at risk of inappropriately being used by the unregulated operations.

Q. WHAT IS RING FENCING?

- A. Ring fencing is well defined in a summary fashion in a white paper prepared on behalf of the NARUC Staff subcommittee on Accounting and Finance, *Ring Fencing Mechanisms for Insulating a Utility in a Holding Company System*. This report is attached as OCA Exhibit DKP-1.

Citing from page 1 of OCA Exhibit DKP-1 and a Fitch Ratings report:

Ring fencing has been defined in different ways but generally involves techniques used to insulate the credit risk of an issuer from the risks of affiliate issues within a corporate structure.

Later, the report contained in OCA Exhibit DKP-1 explains:

In ring fencing, a shell is built around the utility by employing techniques to create a 'package of enhancements.' According to Standard and Poors's (S&P), a properly structured package of enhancements consists of three elements:

1. A special 'Structure,' often including a 'special purpose entity,' structured in a way that reduces the risk of a subsidiary being pulled into bankruptcy along with its parent.
2. A tightly drafted set of covenants, including dividend tests, negative pledges, non-petition covenants, prohibitions from creating new entities, restrictions on asset transfers and inter-company advances, that preserve the well-being and autonomy of the ring-fenced subsidiary.
3. The third element is collateral. If the debt is fully secured by a pledge of all or substantially all of the assets of the subsidiary, the parent, in principle, has less freedom to deal with the assets of the subsidiary. [Footnotes omitted.]

The white paper concludes with some suggested areas to be considered by regulatory agencies relative to ring fencing:

1. Commission authority to restrict and mandate use and terms of sale of utility assets. This includes restrictions against using utility assets as collateral or guarantee for any non utility business.
2. Commission authority to restrict dividend payments to a parent company in order to maintain financial viability of the utility. This may include, but is not limited to, maintenance of a minimum equity ratio balance.
3. Commission authority to authorize loans, loan guarantees, engagement in money pools and large supply contracts between the utility and affiliate companies.
4. Commission authority over the establishment of a holding company structure involving a regulated utility.
5. Expand commission authority over security applications to include the ability to restrict type and use of financing.

These suggestions are very consistent with the restrictions agreed to and memorialized in the Stipulation and Agreement, including provisions that address the use of utility assets, restricted dividend payments, minimum equity levels, and the proposed corporate structure. The Commission already has regulatory oversight over debt and equity issuances and Wyoming law already includes restrictions on the use of securities (see W.S. § 37-6-101).

Q. DOES THIS SAME WHITE PAPER DESCRIBE ANY CIRCUMSTANCES WHERE RING FENCING SEEMS TO HAVE ACTUALLY PROTECTED UTILITY CUSTOMERS?

A. There are numerous stories in the regulatory community about how the regulatory conditions that separated Enron from Portland General protected retail rate customers from being dragged into the Enron bankruptcy. The report summarizes another Enron / Portland General circumstance at page 7:

The Oregon Commission placed certain conditions in its Order approving the Portland General Electric Company (PGE)/Enron merger. Most notable, “PGE must maintain the common equity portion of its capital structure at 48% or higher unless the Commission approves a different level, and must notify the Commission of certain dividends and distributions to Enron.” The 8-notch bond rating differential between PGE and Enron would seem to indicate a successful ring fencing.

Q. HOW DOES THE STIPULATION AND AGREEMENT ADDRESS THIS CONCERN ABOUT INADEQUATE ISOLATION OF THE UTILITY WITHIN THE CORPORATE STRUCTURE?

A. Several conditions are included that have the effect of isolating the utility within the corporate structure and limiting the non-regulated operation’s access to utilization of the utility’s assets. There are also pricing and allocation provisions that limit the regulated operation’s ability to subsidize the non-regulated operations. Finally, there are terms that specify access to corporate books and records, assuring regulators the opportunity to examine any transactions of the utility that also involve unregulated affiliates.

The first ring fencing condition prohibits Source Gas Distribution from holding non-utility diversified holdings and investments with a few noted exceptions. The first exception is for appliance sales. Kinder Morgan has a number of offices throughout its service territory where customers can purchase natural gas appliances. The selling of appliances by Kinder Morgan – or its successor Source Gas Distribution – is not a regulated activity. Yet, it is primarily an activity incidental to the natural gas distribution business and does not appear to merit its

own corporate entity. The repair business, wherein the distribution utility sells appliance repair services, is similarly situated as being an add-on service to the primary business of gas distribution and sales. It is our expectation that the records for these unregulated activities (sales, expenses, and investment) will be isolated from the costs and revenues of the regulated business.

Having explained the exceptions, I wish to return to an explanation of the prohibition against Source Gas Distribution holding any non-utility diversified investments or holdings. This condition is essential, since it creates an absolute separateness between the utility operations and other corporate affiliate entities. This separateness allows the utility to stand on its own – without subsidizing or being subsidized by other corporate operations. It also allows for a better determination of the truly incurred cost of utility operations. And, when combined with some of the other ring fencing provisions, it eliminates the probability that utility assets would be caught-up in a general corporate bankruptcy or other financial situation that might put the utility's assets at risk.

Q. IS THE ESTABLISHMENT OF WRITTEN COST ALLOCATIONS THE SECOND RING-FENCING PROVISION?

A. Yes. Section II(C) of the Stipulation and Agreement details the cost allocation arrangement agreed to by the Parties. Pursuant to this provision, Source Gas Distribution would file a cost allocation manual no later than December 31, 2007, although it is anticipated to be filed earlier than this no-later-than date. Prior to filing the manual, Source Gas Distribution would meet with the OCA to discuss the proposed methods to be contained in the manual, and to allow the OCA the opportunity to react to the proposal(s). The manual would be filed with the Commission as a compliance filing, allowing the Commission and its staff an opportunity to review the manual and take whatever other action seemed appropriate or necessary. The intention is that an understanding of Source Gas Distribution's allocations would be reached before the next rate case is filed allowing one less issue in what is already a complex matter.

The allocations processes in the manual are expected to address allocations among the states served by Source Gas Distribution. It is also expected to address the general pricing methods to be used when non-arm's length affiliate transactions occur between Source Gas Distribution and other entities within the same corporate family. The Parties have already stipulated:

- For non-arm's length affiliate transactions where Source Gas Distribution is providing a service, product, or use of assets to a non-regulated affiliate/parent/subsidiary, the price shall be presumed to be reasonable if it is priced higher of fully allocated costs or prevailing market prices; and
- For non-arm's length affiliate transactions where Source Gas Distribution is obtaining a service, product, or use of assets from a non-regulated affiliate/parent/subsidiary, the price shall be presumed to be reasonable if it is priced at the lower of fully allocated costs or prevailing market prices.

This pricing arrangement is meant to limit the ability of the corporation to shift costs to the regulated entities to the utility through inappropriate policies. It is also meant to prevent the utility from paying more to an affiliate than it would pay to an unrelated third party in the market.

Q. WHAT IS THE NEXT PROTECTION CONTAINED IN THE STIPULATION AND AGREEMENT RELATED TO THIS GENERAL AREA OF RING FENCING?

A. Source Gas Distribution has openly and willingly agreed to allow the Commission, the Commission staff, and the OCA access to the transaction details necessary to confirm that any affiliate transactions are being handled properly and pursuant to the agreed upon methods and formulas. This access would, of course, be done pursuant to applicable Wyoming statutes and Commission rules. Source Gas Distribution agrees to carry the burden of showing why any questions or data requests set forth pursuant to this agreement are invalid, immaterial, or irrelevant if they wish to challenge the request for the information. This properly

places the burden with the utility, unlike many situations where the burden of showing why the data is needed is shifted to the requesting party.

It also takes a positive step in showing that the management and owners of Source Gas Distribution intend to be fully open to proper regulatory processes and reviews. This is a positive indication about the new owners, particularly when OCA has not had prior experience working with Source Gas Distribution, or its affiliates, on regulatory matters.

Q. IN ADDITION TO ALLOWING REGULATORS ACCESS TO SPECIFIC AFFILIATE TRANSACTIONS, DOES SOURCE GAS DISTRIBUTION ITSELF INTEND TO SUBMIT INFORMATION TO THE COMMISSION ABOUT ITS AFFILIATE RELATIONSHIPS?

A. Yes. Source Gas Distribution has agreed, in Section II(E) of the Stipulation and Agreement to file, in 2008, 2009, and 2010, informational reports setting forth information about its transactions with affiliates. After this initial three year period, there would be discussions about whether the reports should be continued or were no longer necessary.

The filing of this informational report is part of the overall process to which Source Gas Distribution has agreed in order to make its operations more transparent. This should eliminate much of the hide-and-seek that is often played between regulators and the utilities they regulate.

Q. IS SECTION II(F) SIMPLY A REITERATION OF SOMETHING THAT SOURCE GAS DISTRIBUTION WOULD BE REQUIRED TO DO ANYWAY, IF ITS APPLICATION WERE APPROVED?

A. Yes. Section 223 of the Commission's Rules requires

Privately owned gas and electric utilities shall maintain their accounting books and records on a uniform basis. The accounts will be numbered and titled in the same manner as the Uniform System of Accounts promulgated by the Federal Energy

Regulatory Commission or the National Association of Regulatory Utility Commissioners.

This is essentially the same requirement that Source Gas Distribution has agreed to in the agreement of the Parties. The inclusion of this provision came from the frustration that OCA experienced in Kinder Morgan's recent rate case when trying to audit the books. This is simply a good reminder of the accounting expectations for natural gas distribution utilities.

Q. IS THERE ONE LAST PROVISION RELATED TO OCA'S GENERAL CONCERN ABOUT CORPORATE SEPARATENESS?

A. Yes. The last provision related to OCA's first area of concern finds Source Gas Distribution agreeing not to guarantee the financial obligations of any of its corporate affiliates. Furthermore, Source Gas Distribution agrees not to pledge any of its assets as security or collateral for any obligations not related to provision of regulated utility services.

The cost of the prudent, used and useful utility assets are included in the rates paid by customers. While this does not give customers ownership rights to those assets, customers should have reasonable assurance that those assets will be used and available for the provision of utility service. Without a prohibition against pledging those assets to guarantee funds that are used in non-utility operations, the future of those assets is put at risk. Consider the situation where utility assets are used to guarantee debt for the parent corporation. If that parent is unable to repay the debt, it is likely that the assets would be sold or otherwise seized, perhaps under the jurisdiction of the bankruptcy court. Regulators no longer have oversight of the matter, and customers are no longer reasonably assured the use of those assets.

This is a critical provision of the Stipulation and Agreement.

Q. MS. PARRISH, WHY ARE THE ABOVE DESCRIBED PROVISIONS IMPORTANT?

A. These provisions are important to provide a reasonable assurance that there will be no inappropriate mixing of utility funds, assets, and costs with those of the non-regulated entities. By having specific, enforceable provisions, the Commission has some recourse if there is a problem that occurs.

Q. WHAT IS THE OCA'S NEXT AREA OF CONCERN?

A. Our second area of concern is that Source Gas Distribution's ability to access the capital reasonably necessary to finance its on-going operations may be restricted, and that cost associated with the capital that it is able to obtain will not be reasonably priced.

Q. WHAT AGREEMENTS DID THE PARTIES REACH IN RESPONSE TO THE OCA CONCERN?

A. The first condition that is meant to mitigate this concern is found at Section II (H) of the Stipulation and Agreement. This provision requires Source Gas Distribution to make a showing in each rate case within the five year period following the closing of the MBO that its cost of capital is no more than what would have otherwise been requested in rates absent the MBO.

Mr. Freeman discusses extensively both this concern, and the responsive provision, in his prefiled, direct testimony.

Q. IS THERE AN ADDITIONAL PROVISION OF THE STIPULATION THAT IS MEANT TO ADDRESS THE OCA'S CONCERN ABOUT ADEQUATE AND REASONABLY PRICED CAPITAL AVAILABILITY?

A. Yes. The provision found at Section II(I) of the agreement places some restrictions on dividend payments, if the dividend would drop Source Gas' equity level below 40% of its total capitalization. The dividend restrictions will assist in keeping the debt / equity ratio in balance, instead of reducing the equity balance

to an unreasonable level where corporate operations will have to be financed with heavy levels of debt. Having too much debt in one's capital structure is often viewed unfavorably by rating agencies (as recently evidenced by the downgrading of Kinder Morgan's debt rating). This could raise the cost of debt and the overall cost of utility service. It could also make debt less available to Source Gas Distribution, and thus, *adversely affect the utility's ability to serve the public.*

Q. DOES THE STIPULATION AND AGREEMENT ALSO STATE THE JOINT APPLICANTS' INTENTION NOT TO INCLUDE ANY ACQUISITION PREMIUM OR AMORTIZATION THEREOF IN WYOMING DISTRIBUTION RATES?

A. Yes. The Joint Applicants have stated their intention not to include any of the acquisition premium in Wyoming rates. But, the language in the Stipulation and Agreement takes this offer a step further, in that it requires a showing in the next rate case that none of the transaction costs have been included in rates. This is more than just the acquisition cost itself.

Essentially, this provision reiterates and better defines the provision already found in the statute at W.S. § 37-1-105, which states, "No charge for expenses in connection with any application under this act may be included in the rates charged to Wyoming customers."

Without the prohibition of including the transaction costs in rates, all other things being equal, customers would be worse off than if the transaction had not occurred. Pursuant to the agreement, the Joint Applicants have agreed not only to exclude these costs from rates, but to also make a showing that they have done so. This leads to the next general area of concern of the OCA: what is a transaction cost versus transition cost of implementing operations under the new structure?

Q. DOES THE STIPULATION AND AGREEMENT ADDRESS THE MATTER OF TRANSACTION VERSUS TRANSITION COSTS?

- A. Yes. The OCA is concerned about whether we, and the Commission, would have the ability to identify what the reorganization costs are at the time of the next (and subsequent) rate case(s). We are concerned that there may not be a clear means of identifying the costs that were incurred in the process of getting approval of the change in ownership and transfer of assets versus the costs that will likely be incurred in the process of transitioning from the old corporate entity and structure to the new corporate entity and structure. We have termed our concern transaction versus transition costs.

Q. HOW DOES THE STIPULATION AND AGREEMENT ADDRESS THIS CONCERN?

- A. This matter is addressed through a reporting requirement. Source Gas Distribution has agreed to file, no later than October 1, 2008, a report that describes the costs and categorize them as either transaction or transition costs.

These reports will be very helpful in assisting with the Commission's and the OCA's understandings of the costs to be excluded relative to the transaction. Yet, this may not put the issue to rest. As indicated earlier, there is a fine line between the transaction and transition costs. For example, the distribution utility is in the process of implementing new billing arrangements and would have made billing changes regardless of whether changes in ownership occurred. But, we understand that the type and extent of changes being made may be different than if the transaction had not occurred. Thus the question: what portion, if any, of the cost of the new billing arrangement should be associated with normal, on-going operations and what portion should be attributed to a cost associated with the transaction and excluded from rates?

The required reports will at least offer Source Gas Distribution's view of this and provide a starting point of the discussion. Without an agreement to track and report on these costs up-front, it could be very difficult to recreate this categorization later.

Q. IS THE PROPOSED ACTION DESCRIBED IN SECTION II(L) PRIMARILY RECOGNITION OF A NECESSARY COMPLIANCE MATTER?

A. Yes. This provision addresses the need to modify the existing filed tariffs to recognize that Kinder Morgan, Inc. is no longer to be the entity providing natural gas distribution service in Wyoming. Source Gas Distribution will utilize the process spelled out in Commission Rule 219 to assure that the filed tariffs are properly updated.

Q. HOW IS IT IN THE PUBLIC INTEREST TO REQUIRE THE PRESIDENT OF SOURCE GAS DISTRIBUTION TO MEET ANNUALLY WITH THE COMMISSION AND THE OCA?

A. This is another provision meant to assist the OCA and Commission in maintaining a general level of knowledge about Source Gas Distributions' Wyoming operations. While we realize that the Commission could call for a command performance by any regulated company at its discretion, the Commission has generally used this authority judiciously – generally when there is a problem it would like to have addressed. Instead, this provision is meant to provide a scheduled opportunity to discuss important issues outside of a formal or contested setting. While we understand how busy the Commission is and how full schedules become, this is an important provision. It requires Source Gas Distribution to maintain an on-going dialogue with its regulators on current issues, and allows the Commission to informally ask about things it may have on its mind. The responsibility of the Commission to oversee regulated utility operations requires an informed Commission.

Q. IS THE OCA CONCERNED ABOUT CUSTOMER CONFUSION THAT MAY RESULT FROM THE REORGANIZATION AND CHANGE IN OWNERSHIP?

- A. Yes. It is important to the OCA that a reasonable effort be made to provide customers adequate information about any changes that take place as a result of approval of the application in this docket. In any situation such as this, it is important that customers be informed of significant changes related to their monopoly distribution provider. However, the situation in this case may be further complicated by the timing of the upcoming Choice Gas selection and name changes associated with the utility distribution operations.

The timing aspects of this case are particularly troubling relative to potential customer confusion. The hearing on this matter is expected to conclude during the first few days of March, and we hope that a Commission decision of approval follows on the heels of that hearing. The transaction would then close shortly after. Laid on top of this are the dates related to the Choice Gas Program. Generally, educational materials are prepared in March, mailed to customers in early April, with the selection period ending around May 1st. The possibility of customer confusion is enormous if the matter is not properly handled.

Q. HOW DOES THE STIPULATION AND AGREEMENT ADDRESS THIS CONCERN?

- A. The Stipulation and Agreement provides that Source Gas Distribution will allow the OCA a brief opportunity to comment on any of its customer education material prior to the time that these materials are provided to customers (e.g., bills stuffers) or released for public consumption (e.g., newspaper ads). This will allow the OCA the chance to express our concerns and express our opinion as to whether the proposed notices help alleviate or simply add to the level of customer confusion that could occur.

Furthermore, Source Gas Distribution will be submitting the customer notifications to the Commission on an informational basis. This will allow the Commission to remain informed, and to be aware of the information if, or as, customer calls are received about the changes that are occurring. While Source

Gas Distribution will not be seeking formal Commission approval of these notices, the Commission will retain all of its current oversight authority, if a problem should arise.

Q. WHY IS IT IMPORTANT FOR SOURCE GAS DISTRIBUTION TO PROVIDE INFORMATION TO THE COMMISSION ABOUT THE IMPLEMENTATION OF ITS NEW BILLING SYSTEM?

A. Changing utility billing systems is not always a process that is transparent to customers, regardless of the efforts made for customers to be unaffected by the change. The Commission has had at least one recent experience of significant problems that occurred when billing systems were modified at the same time that a change in ownership occurred. Hence, the OCA is particularly sensitive to a billing and ownership change occurring concurrently.

Yet, we do not want to presume that a problem will occur. Clearly if there is a problem, the Commission has authority to take any additional actions that seem warranted under the circumstances. So, the balance reached in the Stipulation and Agreement, at Section II(O) is that Source Gas Distribution will make a presentation (written, oral, or both) to the Commission about any problems or concerns that have arisen, if any. This presentation is to be made no later than 45 days following the end of the second billing cycle under the new system. Utilization of the new billing system is expected to begin early this summer.

This provision allows for a scheduled time and place to discuss the matter. Source Gas Distribution is on notice that it should track complaints and concerns about this matter as it will need to make a report to the Commission. It is also on notice that some explanation and public accountability is expected if there are more severe problems with this process than anticipated.

Q. MS. PARRISH, WHAT IS THE OCA'S FINAL AREA OF CONCERN ABOUT THE PROPOSED TRANSACTION?

A. The last issue area relates to compliance and enforcement of the agreed upon provisions of the Stipulation and Agreement.

Q. HOW DOES THE STIPULATION AND AGREEMENT ADDRESS THIS CONCERN?

A. Section II(P) simply indicates that the Parties are free to pursue actions that they think are appropriate if any of the Parties fail to comply with the terms of the Stipulation and Agreement. It does not spell out any particular penalty or cure for particular violations, since there are such a variety of actions contained in the agreement. Violations of failing to make certain showings in the next rate case would likely warrant a different response than would a failure to file a report within the prescribed time. Thus, it was best to acknowledge that there could be ramifications for failure to comply with the Stipulation and Agreement, without spelling out each possible response to each possible situation.

Q. IS IT YOUR INTENT THAT THE STIPULATION AND AGREEMENT BE TREATED AS A PACKAGE, RATHER THAN A CAFETERIA STYLE DOCUMENT, WHERE THE COMMISSION IS INVITED TO PICK AND CHOOSE PROVISIONS AT WILL?

A. Yes. While we recognize that the Commission has the authority to do what it believes is most appropriate and beneficial to satisfy its vision of what is in the public interest, the OCA strongly urges the Commission to treat the individual provisions of the Stipulation and Agreement as if they were inextricable from the other conditions. In doing so, the Commission will maintain the delicate balance that was achieved by the Parties during negotiations. It is our hope that the conditions contained in the Stipulation and Agreement will not only satisfy the OCA but will also resolve any issues that have been identified by the Commission and its advisory staff.

We were not striving for perfection when crafting this agreement. Instead, the Parties worked cooperatively to establish a strong but reasonable level of

regulatory oversight. It is in this context that we ask the Commission to approve the Stipulation and Agreement as it is, without modification, and in conjunction with approval of the Stipulation and Agreement in the companion application. Yet, if there are relatively minor concerns that are troubling, we will gladly offer our opinion as to whether a modest change will skew the delicate balance achieved by the Parties. We would rather entertain the question of whether we are willing to accept a modest change than risk the Commission throwing the baby out with the bathwater.

However, if the Commission finds that we have completely missed the mark, then the Parties are asking for the opportunity take a few days to confer and see if we can revise the Stipulation and Agreement enough to satisfy the Commission. If we fail to then reach an agreement acceptable to the Parties and the Commission, we would likely seek permission from the Commission to litigate any and all unresolved issues in a fully contested hearing. Understanding that the decision to allow the second hearing would still be subject to the discretion of the Commission, I have been informed by my attorneys that arguments in support of this process would center on the completeness of the record and the due process rights of the Parties.

Q. DOES THAT CONCLUDE YOUR PREFILED, DIRECT TESTIMONY?

A. Yes, it does. I look forward to responding to any questions the Commission or its advisory staff may have at the hearing.