

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF DELTA NATURAL)
GAS COMPANY, INC. FOR AN ORDER)
AUTHORIZING THE PURCHASE OF)
ALL OF THE ISSUED AND OUTSTANDING)
STOCK OF THE TRANEX CORPORATION)

CASE NO. 97-140

O R D E R

On March 19, 1997, Delta Natural Gas Company, Inc. ("Delta") filed its application requesting approval to acquire all of the issued and outstanding stock of TranEx Corporation ("TranEx"). Delta further requested that the Commission grant it a Certificate of Convenience and Necessity to consummate the purchase of the TranEx stock and grant approval of a transportation tariff for TranEx. Upon the transfer of ownership, TranEx will become a wholly owned subsidiary of Delta.

TranEx owns an intrastate natural gas pipeline running from Collins Fork in Clay County, Kentucky through Estill and Jackson counties to an existing interconnection with Columbia Gulf Transmission pipeline at Speedwell in Madison County, Kentucky. The pipeline is currently leased to Equitable Resources Energy Company ("Equitable"). Delta is currently subleasing the pipeline from Equitable Resources Exploration ("EREX"), a division of Equitable.

Transfer

On May 30, 1997, Delta filed supplemental information regarding the proposed transfer. In that filing Delta stated that the pipeline would be used initially to transport gas

from Columbia Gulf to Delta's Canada Mountain storage field and that the pipeline would also be available to transport gas for EREX or anyone else. Delta also stated that the pipeline was a vital link in its system in that it would help tie Delta's system together and would facilitate the movement of gas on a long-term basis, that it will need to use the pipeline whether or not it completes the purchase of TranEx, and that the purchase as proposed is the least expensive alternative for Delta's customers. Delta proposes to continue operating TranEx in the same manner after the stock purchase as it is now being operated pursuant to its existing sublease agreement with EREX.

KRS 278.020(4) and (5) provides in part that "No person shall acquire or transfer ownership of, or control, or the right to control, any utility under the jurisdiction of the commission by sale of assets, transfer of stock, or otherwise, . . . without prior approval by the Commission. The Commission shall grant its approval if the person acquiring the utility has the financial, technical, and managerial abilities to provide reasonable service. . .and if the transfer is consistent with the public interest. . . ."

Based upon the information filed in the record in this proceeding, the Commission finds that Delta has the financial, managerial, and technical expertise to operate the TranEx pipeline and that the transfer of control is in accordance with the law, within Delta's corporate purposes, and is necessary and consistent with the public interest. Therefore, the purchase of 100 percent of the stock of TranEx should be approved with certain modifications, discussed herein, regarding the manner in which the transfer is recorded for regulatory accounting purposes.

Transportation Tariff

Delta proposed a twenty-five cent (\$0.25) per 1000 cubic feet transportation tariff for TranEx. TranEx would charge this rate for transportation of gas on the pipeline contingent upon the release of capacity from Delta to TranEx on a month-to-month basis. Delta would not charge TranEx for the released capacity. However, based on information filed in the May 30, 1997 supplement, TranEx is proposing to charge Delta, or any other entity desiring to transport gas on the pipeline, \$0.25 per Mcf to transport gas. It is not in the best interests of Delta's customers to allow TranEx to charge Delta a \$0.25 per Mcf rate to use the pipeline which Delta may currently use at no charge.

The \$0.25 per Mcf rate is not adequately supported by the cost information provided by TranEx. In support of its proposed transportation rate, TranEx estimated its annual cost would include \$30,000 in operating and maintenance expense, \$3,615 in property tax, \$78,594 in interest expense, and \$71,100 for costs associated with an existing lease TranEx has with Circle R Company. Section 4 of the Equitable-TranEx lease, entitled "Additional Consideration," provides in part that, the Lessee (Equitable) agrees and promises to pay for any and all ad valorem property taxes as well as any and all maintenance costs required to keep the property in essentially the same condition as when received by Lessee, normal wear and tear excluded. Since these and other costs outlined in Section 4 are to be paid by the Lessee for the next two years, it is not appropriate to include these costs in the cost of service for any customers TranEx serves based upon the release of capacity by Delta to it on a monthly basis.

Section 8 of the Delta - EREX sublease, which has been in effect since April 28, 1989, entitled "Maintenance and Repairs," provides in part that, the Sublessee (Delta) shall

maintain the pipeline in good operating and mechanical condition, normal wear and tear from authorized use excepted. Therefore, any costs so incurred by Delta have been embedded in its cost of service since the inception of the lease. Consequently, inclusion of these costs in TranEx's cost of service would result in double recovery of those costs. TranEx should review its costs in light of the findings herein and refile a tariff to be effective at the time the Equitable lease is terminated. Any tariff so filed should reflect only those costs TranEx is actually incurring. Based on the foregoing, the Commission finds that TranEx's proposed transportation tariff is not adequately supported by the evidence in the record and should therefore be denied.

Regulatory Accounting Issues

The Stock Purchase Agreement ("Agreement") filed with the application shows that TranEx shareholders have agreed to sell to Delta 100 percent of the issued and outstanding stock of TranEx for a total purchase price of \$1,950,000. The purchase price consists of a cash payment of \$1,000,000 to the shareholders at closing, an additional \$150,000 cash payment to the shareholders for a Non-compete Agreement, and Delta's agreement to repay in full the balances outstanding, as of the date of closing, on the shareholder advance and the PNC bank loan. These loans had balances of \$470,000 and \$330,000, respectively, as reported in the May 30, 1997 supplemental filing.

Section 13 of the Agreement provides details regarding the manner in which the parties are proposing to account for the stock purchase and sale. Delta's May 30, 1997 filing included information supporting this accounting treatment stating that it was based on Accounting Principles Board Opinion No. 16, Accounting for Business Combinations, ("APB16"). Delta stated that APB16 requires that any operating leases involving future

lease payments that are deemed to be "above market" or "below market" must be assigned a fair value in the allocation of the purchase price. Based on this requirement, Delta assigned the Equitable lease a value of \$1,000,000 which Delta stated was equal to the present value of the future lease payments receivable under the lease. Delta proposed the following journal entry to reflect this accounting treatment on TranEx's books:

Dr.	Plant in Service	\$4,300,000	
Dr.	Intangible Assets:		
	- Lease	1,000,000	
	- Non-compete Agreement	150,000	
Cr.	Accumulated Depreciation		\$2,400,000
Cr.	Acquisition Adjustment		1,100,000
Cr.	Notes Payable to Bank		330,000
Cr.	Notes Payable to TranEx Shareholder		470,000
Cr.	Shareholder's Equity		1,150,000

This entry reflects the original cost of the utility plant with the associated depreciation as required in the Uniform System of Accounts Prescribed for Natural Gas Utilities ("USoA"). However, this entry also results in the capitalization of an operating lease to the Balance Sheet. The USoA in paragraph 19B of the General Instructions states in part that, "Changes in estimates. . .or changes in circumstances. . .shall not give rise to a new classification of a lease for accounting purposes. . . ." The Commission concludes that the stock purchase approved herein does not in and of itself change the character of the lease. Absent changes in the terms of the lease that would result in a reclassification of the lease from an operating to a capital lease, the Commission does not believe it appropriate to record the operating lease on TranEx's books.

The Commission has also considered Delta's proposal to record the \$150,000 paid for the Non-compete Agreement on TranEx's books and has not found adequate

justification for recording the additional amount paid to the current shareholders as an asset. The Non-compete Agreement specifies that the seller is prohibited from competing with the buyer in the business of providing computer-related equipment sales and services. The record in this case does not include any information regarding the extent of any business TranEx is conducting in the area of computer equipment sales and related services. Therefore, the Commission concurs with the opinion expressed in the Guide to Preparing Financial Statements¹ wherein the authors conclude that if a covenant does not have economic substance, payments under the agreement are in substance additional compensation for the assets purchased. The Commission finds that the Non-compete Agreement does not have economic substance and therefore should not be reflected on TranEx's books.

Removing the impact of the lease and the Non-compete Agreement from Delta's proposed journal entries to be reflected on TranEx's books results in the following revised journal entry:

Dr.	Plant in Service	\$4,300,000	
Dr.	Acquisition Adjustment	50,000	
	Cr. Accumulated Depreciation		\$2,400,000
	Cr. Notes Payable to Bank		330,000
	Cr. Notes Payable to TranEx Shareholder		470,000
	Cr. Shareholder's Equity		1,150,000

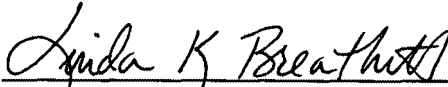
¹ Clay, John R., CPA, and Stephen D. Holton, CPA, Guide to Preparing Financial Statements, Vol. 1, page 3-75, paragraph 325.10, Practitioners Publishing Company, August 1996.


IT IS THEREFORE ORDERED that:

1. The purchase of 100 percent of the issued and outstanding stock of TranEx by Delta as proposed in the Stock Purchase Agreement, as modified herein, is hereby approved.
2. Delta is hereby granted approval to consummate the purchase of the TranEx stock.
3. Delta shall file the journal entries made on its books as well as on the books of TranEx to effect the transaction in accordance with the USoA and the Commission's findings herein within 30 days of the date of closing on the purchase.
4. The transportation tariff proposed by Delta for TranEx is hereby denied.

Done at Frankfort, Kentucky, this 27th day of June, 1997.


PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:


Executive Director