COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE JOINT APPLICATION OF SIGMA GAS CORPORATION AND SALYERSVILLE GAS COMPANY, INC. FOR APPROVAL OF THE ACQUISITION OF ASSETS OF SALYERSVILLE GAS COMPANY, INC.	)	CASE NO. 93-349

O R D E R

On September 4, 1993, Sigma Gas Corporation, Inc. ("Sigma") and James Lyon, Chapter 11 Bankruptcy Trustee for Salyersville Gas Company ("Salyersville"), applied for approval to transfer the assets of Salyersville to Sigma pursuant to terms of a letter agreement between the applicants dated April 16, 1993, and a plan of liquidation confirmed by the bankruptcy court on July 16, 1993. Eli Warach, M5A1, BTU Pipeline, Inc., and Richard Williams intervened in this proceeding. A public hearing was held on the joint application on November 19, 1993.

KRS 278.020 provides that in order to transfer ownership or control of a utility, prior Commission approval must be obtained. The Commission shall approve the transfer if the person acquiring the utility has the financial, managerial, and technical abilities to provide reasonable service. The statute further provides that the Commission shall grant, modify, refuse, or prescribe appropriate terms and conditions with respect to the application. Sufficient evidence has been presented by the parties in this proceeding for the Commission to approve the transfer subject to certain conditions set forth herein. In evaluating the evidence of financial ability, the Commission has considered not only the financing arrangements to purchase the assets but the projected financial statements and cash flow as well. Technical expertise has been evaluated considering the evidence of record relating to gas supply and related issues. Managerial abilities have been evaluated based upon the management contract and representations by the joint applicants regarding further operation of the system.

Financial Issues

Sigma proposes to purchase Salyersville's utility assets for $100,000. To finance the purchase, Sigma proposes to borrow $150,000 from the Citizens National Bank under a 5 year balloon note at 9 percent interest per annum. The loan proceeds in excess of the purchase price will be used to pay legal expenses (which are to be capitalized later) and provide initial cash flow.

Several aspects of this transaction are troubling. Sigma projects a post-transfer cash flow for calendar year 1994 of approximately ($11,000). It intends to offset the negative cash flow with funds obtained in the initial borrowing to purchase the utility assets. At the same time, its cash flow statement shows that Sigma shareholders, Barkley Sturgill, Grady Conley, and Estill Branham, propose total annual dividend payments of $6,000 in the face of the company's projected negative cash flow. Payment of cash dividends out of funds borrowed to support a negative cash flow is not a particularly prudent gesture. If such payments are in fact made while the company is experiencing a negative cash flow, the Commission will disallow rate recovery for them.

Managerial Issues

Sigma has entered a management contract with Estill Branham, a shareholder, director, and President of Sigma. This is a less-than-arms-length transaction. Mr. Branham, through the management contract, is given sole authority by Sigma to enter, modify, and terminate contracts. He is responsible for paying Sigma's bills and therefore will review and approve payments to himself. Mr. Branham and his family provide services to gas utilities through a corporation named KISU Service Company, Inc. Pursuant to the terms of the management contract, he will be in a position to hire and pay family members without oversight from the board of directors. It is inappropriate for the board of directors of Sigma to delegate their responsibility for oversight regarding certain transactions for Sigma. The Commission, therefore, finds the term of the management contract transferring complete control and discretion to Mr. Branham to contract with any party should be modified to the extent that the board of directors should review and approve any transactions involving Mr. Branham or his family members which are not otherwise specifically covered by the management contract.

The management contract provides that Mr. Branham will be paid a minimum of $26,400 in the first year up to a minimum of $42,000 in the third year. This compensation is based upon a guaranteed fee of ten dollars per billing month for each customer of Sigma. This fee covers Sigma's administrative expenses and, according to the agreement, Mr. Branham's compensation for its day-to-day operation including billing, maintenance and emergency repairs, bookkeeping, and preparation of financial reports. It does not include materials, supplies, meters, repair or replacement parts, equipment, contract labor, or consultants for Sigma.

Salyersville customers currently pay a minimum bill of $7.00 which includes the use of up to 1 mcf of gas. The current cost to Salyersville of 1 mcf of gas is $3.10 yielding a contribution to the total fixed costs of Salyersville of $3.90. Anything over 1 mcf of gas consumed yields a fixed cost contribution of $3.00 per mcf. It is apparent that payment of a management fee based on $10 per customer per month will neither improve nor maintain the current financial condition of this utility which it should be remembered, is being transferred by the bankruptcy trustee.

Moreover, Mr. Branham's management fee will increase $15,600 between year one and year three. This increase is not predicated upon achievement of any service goal but is simply guaranteed in the five year contract. At the hearing, Mr. Branham was questioned about the compensation under the terms of this contract as compared to a similar contract under which he manages Johnson County Gas. (Mr. Branham receives $18,000 annually to manage the Johnson County system which has nearly three times as many customers as the Salyersville system). Mr. Branham's only justification for the disparity was that he was having a good day when he negotiated this contract.

Mr. Branham's good day notwithstanding, approval of this management contract as part of this transfer will do little to ensure that the Salyersville Gas customers have continued gas service at a reasonable cost. If there is any hope that this system will achieve financial viability and stability, the amount of the management fee recoverable in the rates of the utility customers must be limited. The Commission has compared the management fee and duties prescribed in the management contract herein with the fees and duties performed by Mr. Branham for the trustees of Johnson County Gas Company. The $18,000 management fee approved by the trustees and the Commission for the management of Johnson County Gas was adjusted for inflation over the last three years using the CPI Detailed Report, October 1993. Using a 38 percent customer ratio (Salyersville currently has 38 percent as many customers as Johnson County Gas) multiplied by the management fee, adjusted for inflation and determining the per customer amount per month, the Commission has determined that the management fee must be limited to $2.97 per customer, per billing month. Any compensation above this amount paid to Mr. Branham will be solely the responsibility of the shareholders of Sigma. The Commission will monitor Sigma's post transfer financial transactions by having Sigma file copies of its monthly general ledger.

Technical Issues

Gas Supply

Salyersville has had a history of gas supply disruptions since it began operations in 1984. Thus, Sigma's gas supply arrangements are of primary importance in its proposal to assume ownership and control of the system.

Sigma submitted copies of two gas supply contracts. One is with Devco Energy, a local gas production and gathering company whose assets allegedly have been purchased by a Texas corporation. Devco also appears to have majority ownership of, and operates, the gas pipeline through which both sources of gas must be moved for delivery to the Salyersville system (a pipeline originally owned and operated by Inland Gas Company, an interstate pipeline operator). The second contract, characterized by Sigma as a back-up supply source, is with Equitable Resources Exploration ("EREX"), a major national gas producer with gas production facilities in eastern Kentucky.

Devco warrants in its contract that it can supply up to 1,000 mcf per day, enough to meet all of Sigma's needs from its own wells. However, in response to a data request, Sigma has been unable to provide any documentation from Devco describing its production capabilities or the number of its gas wells available for Sigma's needs.

According to EREX's contract, it will provide gas on an as-available basis, i.e. its deliveries to Sigma could be interrupted. Monthly nominations already submitted by Sigma to EREX should meet the historical needs of Sigma's customers and EREX is clearly able to provide the amount of gas nominated by Sigma. However, for EREX gas to reach Sigma during the winter months, a compressor is needed at the point where EREX gas enters the Devco pipeline. Sigma acknowledged at the hearing that adequate pressure could not be maintained during extreme temperature drops without compression. No arrangements have been made regarding the installation of a compressor.

Without information regarding Devco's operations which would support its reliability, the Commission cannot conclude that Devco represents a reliable source of gas supply. Sigma provided none. The information requested in this proceeding is identical to that requested and received from Salyersville's previous suppliers and identical to that regularly requested by the Commission from any operator of a gas distribution utility who proposes to use local production as a primary source of supply.

Although Sigma characterizes the EREX gas supply as a "back-up," EREX is the only reliable source of gas proposed by Sigma, but only if a compressor is installed. Therefore, the following term is prescribed for approval to acquire the assets of Salyersville by Sigma: A compressor should be installed at or near the EREX point of delivery to Sigma within 15 days of the date of this Order and the installation witnessed by Commission Staff. (If additional borrowing is necessary to finance the installation, that borrowing may require prior Commission approval under KRS 278.300.)

Gas Pricing

The Commission finds the Devco price of $3.10 per Mcf to be reasonable for a warranted supply of gas to Salyersville. If the supply warranted by Devco fails and must be supplemented or replaced by back-up supply, the gas cost to be recovered through rates should be the actual cost of the back-up supply. In no event should the cost so recovered be more than $3.10 per Mcf or the applicable Devco price as adjusted pursuant to the contract. Any adjustment to the Devco price to Sigma will be reviewed in subsequent purchased gas adjustment filings.

After consideration of the application, the evidence of record and being otherwise sufficiently advised, the Commission finds that the following terms and conditions are appropriate prerequisites for approval of the transfer requested herein.

IT IS THEREFORE ORDERED that:

1. Sigma shall cause a compressor to be installed at the point of delivery of the EREX gas supply on or before December 30, 1993.

2. Sigma shall notify the Commission prior to the actual date of installation of the compressor so that Staff may witness installation.

3. The transfer of the assets of Salyersville to Sigma be and it hereby is approved conditioned upon the following:

a. The installation and operation of the compressor has been verified by Commission Staff.

b. The terms of the management contract between Estill Branham and Sigma are modified to reflect rate recovery of a management fee of $2.97 per customer, per billing month. Any compensation in excess of $2.97 shall be the sole responsibility of Sigma's shareholders.

c. The terms of the management contract are modified to provide that the board of directors should review and approve any transactions involving Mr. Branham or his family members that are not covered by the management agreement.

4. Within 10 days of closing Sigma shall file copies of the journal entries reflecting the transfer.

5. Sigma shall file copies of its monthly general ledger within 30 days of the end of the month. The first such monthly report shall be due no later than March 2, 1994, for the period covering the closing date to January 31, 1994.

Done at Frankfort, Kentucky, this 15th day of December, 1993.

PUBLIC SERVICE COMMISSION

Chairman

Robert M. Davis

Vice Chairman

Linda K. Breathitt

Commissioner

ATTEST:

Don Mills

Executive Director