BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the Matter of the Application of Southern Union Company d/b/a Missouri Gas Energy for Authority to Acquire Directly or Indirectly, up to and Including Fifty Percent (50%) of the Equity Interests of CrossCountry Energy, LLC, and to Take All Other Actions Reasonably Necessary to Effectuate Said Transaction	)))))))	Case No. GO-2005-0019

STAFF MEMORANDUM IN SUPPORT OF STIPULATION AND AGREEMENT

COMES NOW the Staff of the Missouri Pubic Service Commission (Staff) and submits its Memorandum in Support of the Stipulation and Agreement filed in this case:

I. Introduction

Staff has worked with MGE to come to a Stipulation and Agreement (Stipulation) that resolves many of Staff's concerns. Nevertheless, the Staff does not consider that this Stipulation can completely insulate or protect MGE from all potential negative impacts from this transaction. There are a number of reasons for this, including that the Staff has not been able to contemplate every possible event that could have an impact on Missouri ratepayers. The Stipulation only represents the Staff's best effort at this time to protect the public interest and MGE customers from any detrimental impacts of the Cross Country Energy, LLC ("Cross Country") acquisition. The success of the Stipulation depends on Southern Union Company's ("Southern Union" or "Company") representations that it will not engage in any action that is or will be detrimental to its MGE operations. To the extent Southern Union operates contrary to this representation, detriments to its MGE operations can occur.

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The public utility commissions of two states have approved this transaction, Pennsylvania and Massachusetts. The order from Pennsylvania is Attachment A document, and the Massachusetts order will be filed as soon as it is available.

A. Background

Southern Union Company is the parent company of several gas local distribution companies (LDCs). These LDCs operate as separate operating divisions of the Company. Southern Union is also the parent company of a 10,000-mile natural gas pipeline company (Panhandle Energy) that operates as a subsidiary of the Company.

In presenting its view of the potential impact of the CrossCountry acquisition, Staff will briefly describe Southern Union's acquisition history. Southern Union began gas distribution operations in Missouri in February 1994. At this time, Southern Union consisted of two similarly sized LDCs - MGE and Southern Union Gas Company (SUG) of Austin, Texas. For the next six years Southern Union made only one significant acquisition. On December 31, 1997, it acquired Atlantic Utilities Corporation (Atlantic Utilities), a LDC in central Florida. For the next six years, 1999-2004, however, Southern Union embarked on a very aggressive policy of growth through acquisitions.

From November 1999 through September 2000, Southern Union acquired four LDCs, one in Pennsylvania and three in the New England states of Rhode Island and Massachusetts. These LDCs are Pennsylvania Enterprises, Inc., Providence Energy Corporation, Fall River Gas Company, and Valley Resources, Inc. The Commission approved each of these acquisitions.

In June 2003, Southern Union began its foray into the natural gas pipeline business segment through its acquisition of Panhandle Energy of Houston, Texas. This acquisition was approved by the Commission in Case No. GM-2003-0238. Southern Union is now expanding its operations in the interstate pipeline business by seeking to acquire CrossCountry, also of Houston, Texas. With the acquisition of CrossCountry, Southern Union claims it will be one of the five largest pipeline operators in North America.

B. Procedural History

On July 14, 2004, Southern Union filed an Application with the Missouri Public Service Commission ("Commission") for authority to acquire, directly or indirectly, up to and including fifty percent (50%) of the equity interests of CrossCountry and to take all other actions reasonably necessary to effectuate said transaction (transaction). On the same day, Southern Union filed with the Commission its Motion for Expedited Treatment and a Motion for Protective Order.

On July 20, 2004, the Commission issued its order adopting protective order and directing filing. In that order, the Commission directed its Staff to file a pleading not later than 4:00 pm, on July 16, 2004 stating whether or not it would be able to file a memorandum and recommendation in this case by August 16, 2004. In response to that order, the Staff filed its response on July 23, 2004 stating, among other things, that its ability to file a recommendation by August 16, 2004, was contingent upon receipt of prompt and complete responses to data requests from Missouri Gas Energy ("MGE") and Southern Union.

On August 12, 2004, Southern Union filed a Motion for Extension of Time for the Staff of the Commission to File its Recommendation and for Expedited Consideration. Pursuant to said motion, Southern Union requested that the Commission's Staff be given additional time until August 19, 2004 to file its recommendation or a stipulation and agreement.

On August 19, 2004, the Commission issued an Order Directing Filing. By virtue of that order, the Commission directed its Staff to file a stipulation and agreement embodying a settlement of the case or Staff's memorandum and recommendation by no later than 4:00 pm on Tuesday, August 24, 2004. On Tuesday August 24, the Parties requested an additional day to file a Stipulation in lieu of a Staff Memorandum.

Southern Union, MGE, Staff and the Office of the Public Counsel ("OPC") have engaged in discovery and numerous discussions, and as a consequence, a Stipulation was filed in this case. OPC did not join, but will not demand a hearing on the Stipulation. Staff has been able to address most of its concerns but Staff cannot warrant that this transaction will not have any negative consequences on MGE for a number of reasons. First, the Stipulation cannot and, therefore, does not contemplate unforeseen events or conditions that may have a detrimental impact on MGE, such as the downgrade of Southern Union credit rating to junk status. The Stipulation does, however, represent the Staff's best effort at this time to protect the public interest from any detrimental impacts of the CrossCountry acquisition.

C. Unusual aspects of this proposed acquisition

Southern Union is requesting Commission authorization to acquire a 50% interest in CCE Holdings, LLC. A limited liability company, CCE Holdings, LLC (CCE) is a joint venture of Southern Union and GE Commercial Finance Energy Financial Services ("GE"). Southern Union and GE are bidders, through CCE, to acquire a former Enron pipelines from the bankruptcy court. CrossCountry is a Delaware LLC, with its main offices in Houston Texas. It is a holding company for Enron's interests in Transwestern Pipeline, Citrus Corp. and Northern Plains Natural Gas Company. None of these businesses serve Missouri. Enron is in bankruptcy. This acquisition would be through the bankruptcy court proceeding. Southern Union and GE, through CCE, have entered into a Purchase Agreement to acquire all of the equity interests of CrossCountry from Enron and its affiliates and to assume consolidated debt of around $461 million. The original total transaction value is about $2.35 billion. Another bidder has been identified by Enron, that apparently will compete against Southern Union and GE in a bankruptcy court bidding process that is to be held on September 1, 2004. Thus, the total transaction value may be greater than originally planned.

This particular acquisition is different from most in which Staff is involved because this particular asset and purchasing process are part of the Enron bankruptcy. If the other bidder is qualified, the auction process prevents Staff and, Southern Union for that matter, from knowing what the final purchase price will be until September 1, 2004.

Because of the nature of the transaction and the unknowns inherent in such a situation, Staff has attempted to protect the public interest from potential negative consequences by insulating MGE from the transaction through the conditions as set forth in the Stipulation, and specifically the condition that:

> Southern Union agrees that this transaction will not have any detrimental effect on MGE's utility customers, including, but not limited to: increased rates or any effect on quality of service, but agrees that, should such detrimental effects nevertheless occur, nothing in the approval or implementation of the proposed acquisition shall impair the Commission's ability to protect such customers from such detrimental effects.

II. Legal issues

1. Standard for approval

Staff has evaluated this proposal based on the standard for approval that the transaction is "not detrimental to the public interest." In establishing this standard, the Supreme Court recognized that one of the most important functions of the Public Service Commission is to balance competing interests. The Court noted:

> To prevent injury to the public, in the clashing of private interests with the public good in the operation of public utilities, is one of the most important functions of Public Service Commissions. It is not their province to insist that

> the public shall be *benefited*, as a condition to change of ownership, but their duty is to see that no such change shall be made a would work to the public *detriment*. In the public interest, in such cases, can reasonably mean no more than "not detrimental to the public."

In applying this standard to this proposed transaction, Staff examined the nature and level of the impact or effect that the proposed transaction might have on MGE's Missouri customers. The fundamental concern is that the public being served by MGE will not be adversely affected or harmed by this proposed transaction. *Southern Union Co. v. Missouri Pub. Serv. Com'n*, 289 F.3d 503, 507(8^{th} Cir. 2002).

In the merger case involving KPL and KGE, which occurred in 1991, the Commission identified the "public" as Missouri ratepayers when it said: "[t]he Commission has also found that there is potential for a detrimental effect on Missouri ratepayers from the merger through increased A & G and capital costs . . . . . " Case No. EM–91–213, *In the Matter of the Application of The Kansas Power and Light Company*, 1 Mo PSC 3d 150, 159 (1991).

2. Commission jurisdiction

The Commission has jurisdiction under § 393.190.2 RSMo 2000 to review certain acquisitions by Missouri gas corporations. This section states that "no [gas] corporation shall directly or indirectly acquire the stocks or bonds of any other corporation engaged in the same or similar business, unless authorized to do so by the Commission. In a 2002 8^{th} Circuit decision, Southern Union had applied to this Commission for blanket authority to make acquisitions of other utilities, within certain limits, without obtaining any additional authorization from this Commission. When the Commission determined that it did not have authority to issue such blanket authority, Southern Union challenged the Commission's decision and sought to have this section of the Public Utility Law declared unconstitutional. *Southern Union Co. v. Missouri Pub. Serv. Com'n*, 289 F.3d 503, 507(8^{th} Cir. 2002).

In the underlying Commission case, Southern Union sought blanket authority to make non-controlling investments in other utility companies without pre-approval of the Commission. 8 Mo. P.S.C. 3d 287. In that case the Commission determined that it did not have statutory authority to approve Southern Union's application for blanket pre-approval of purchases of other utility companies and that such approval would be detrimental to the public interest. The 2002 8th Circuit decision agreed with the Commission and determined that the statute is constitutional. In so finding, the Court discussed the statute as requiring Southern Union, as a Missouri regulated utility, to obtain authority prior to acquiring the securities of another utility:

> Southern Union is subject to the Commission's regulatory authority, see MO. REV. STAT. §§393.110 to 393.295, including the requirement in §393.190.2 that a regulated gas corporation must obtain the Commission's prior approval before acquiring the securities of another utility, whether or not the other utility operates in Missouri.

Southern Union Co. v. Missouri Pub. Serv. Com'n, 289 F.3d 503, 507(8th Cir. 2002).

This 8th Circuit decision addresses the issue of the scope of the Commission's jurisdiction. The 8th Circuit specifically explained that the Commission's jurisdiction rests on the Commission's statutory mandate to establish "just and reasonable" rates and because of that mandate the Commission needed to consider the potential impact of Southern Union's investments in other companies:

> The statute here at issue is part of Chapter 393 of the Missouri Statutes, which authorizes the Commission to establish "just and reasonable" rates for the local distribution of natural gas, electricity, water, and sewer services. Rate regulation is a complex process. A public utility's investments in other companies can affect its regulated rate of return, if investment losses are allocated to the regulated business. Transactions between affiliated utilities can present rate regulators with difficult issues of preferential treatment and cost allocation. The abuses Congress identified in enacting the Public Utility

> Holding Company Act attest to the long-standing regulatory concern over interlocking ownership and management of public utilities.[1]
> *id*., at 507-508.

These same concerns are present in this case. Southern Union's investment in CrossCountry could affect its regulated rate of return, its cost of capital and investment losses that could be allocated to the regulated businesses. The Court further explains that while Southern Union's acquisition activities may not be detrimental to the public interest it is appropriate for this Commission to have pre-approval authority:

> This concern does not mean that Southern Union's acquisition strategy is necessarily contrary to the public interest, but it tends to confirm the presumptive validity of Missouri regulating that strategy by requiring pre-acquisition approval.

3. Negotiations

Staff has worked diligently with Southern Union to develop conditions that would enable the Staff to present its evaluation of the risks of this transaction to the Commission. Staff has reviewed hundreds of documents and had several lengthy discussions with Southern Union personnel. Southern Union has been responsive to Staff's requests for information albeit there have been issues regarding timeliness and completeness. Conditions are only effective in insulating MGE from the impacts of this transaction, however, if the Staff, OPC and Southern Union can agree on the application of the conditions.

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[1] The Court cited *North Am. Co. v. SEC,* 327 U.S. 686, 701-02 & n. 11, 66 S. Ct. 785 (1946).

III. Resolution of Issues

A. Customer Service conditions

The Company has an ongoing reporting requirement that was initially required pursuant to the Stipulation reached in Case No. GM-2000-43, Southern Union's acquisition of the Panhandle Eastern pipeline. This reporting includes several Call Center performance indicators that assist in determining the level of service being provided to the customer at the Call Center. These two Call Center indicators are the Abandoned Call Rate (ACR) and the Average Speed of Answer (ASA). The Stipulation in Case No. GM-2000-43 established an objective for each indicator that the Company was to meet. These objectives were characterized in the Stipulation as representing the "maximum allowable levels" that the Company should attain.

The objectives were developed by Staff utilizing statistics from the Company's own historical performance for the period of July 1997 through June 1999. The method of developing these objectives to measure the level of service being provided by the Call Center to customers was ultimately agreed to by the parties in the Stipulation. These objectives represent a minimum acceptable level of service that should be provided to the customer. Performance less than the objective indicates a level of service less than acceptable. The Company has also apprised the Staff of improvements it has made in its Call Center technology in the last four (4) years. One would assume that this increased use of improved technology should lead to better performance statistics.

The Company's Call Center service levels performance have deteriorated beginning in November of 2003 and continuing into April of 2004. The objective of 8.5% for the ACR was not met. The ACR climbed as high as 28% during this period. The ASA also did not meet its objective of 75 seconds and at one point reached a high of 489 seconds. Performance indicators for May and June 2004 did finally show some improvement for both of these indicators. However, these numbers reflect performance during summer months which characteristically allow Call Centers of gas companies to post better performance statistics. The Staff will continue to track these statistics to monitor any changes in the performance at the Call Center.

Given the Company's most recent performance indicators since late 2003 and into the present year, the Staff continues to have concerns about the level of service being provided by the Call Center to the customer. This provides additional reasons for the Company to continue its performance reporting uninterrupted into the future. To respond to these concerns, the following condition is in the Stipulation:

1. CUSTOMER SERVICE STANDARDS

> A. Southern Union will, through its MGE operating division, continue uninterrupted its commitment to customer service performance measures and customer service operating procedures originally agreed to by Southern Union, through MGE, and approved by the Commission in its October 21, 1999, Order Approving Stipulation and Agreement in Case No. GM-2000-43 (and also agreed to by Southern Union and approved by the Commission in Case Nos. GM-2000-500, GM-2000-502, GM-2000-503 and GM-2003-0238). The data should continue to be presented in a monthly format and provided on a quarterly basis and may be transmitted to the Staff in an electronic format. The MGE response to the customer service measures will remain as agreed to in Case No. GM-2000-43, with one exception. Specifically, the only aspect of these customer service performance measures and customer service operating procedures as originally agreed to by Southern Union, through MGE, and approved by the Commission in its October 21, 1999, Order Approving Stipulation and Agreement in Case No. GM-2000-43 (and also agreed to by Southern Union and approved by the Commission in Case Nos. GM-2000-500, GM-2000-502, GM-2000-503 and GM-2003-0238) that will cease are certain provisions of paragraph 2.b.) of that Unanimous Stipulation and Agreement, which read as follows: "The Company will credit to customers a like amount (annual revenue requirement) during the subsequent year for the year in which the indicator was exceeded. The credit may be booked to a deferred liability account, if the Company, Staff and OPC agree, until a sufficient amount is accumulated to warrant a credit to customers." This requirement will cease on December 31, 2006. The expiration of this specific term was agreed to and appeared in the Stipulation and Agreement in Case No. GR-2001-292.

B. Other reporting requirements of the Commission orders in Case Nos. GM-2000-43, GM-2000-500, GM-2000-502, GM-2000-503 and GM-2003-0238 are not affected by the provisions of this Agreement.

C. The conditions in this Agreement do not represent Staff's approval of the present level of customer service being provided by the Company. In addition, the service standards set in Case No. GM-2000-43 do not, in the Staff's opinion, represent a high level of customer service and are, in the Staff's opinion, simply a minimum acceptable level of service that should be provided to the customer.

B. Acquisition Premium

Under the Federal Energy Regulatory Commission's Uniform System of Accounts (FERC USOA), amounts paid above the existing book value of acquired utility plant are considered acquisition adjustments. The FERC USOA does not allow acquisition adjustments to be recorded in plant accounts but has created special accounts where this amount is to be recorded. In many state regulatory jurisdictions, including Missouri, acquisition adjustments have not been allowed direct rate recovery and are treated below the line for ratemaking purposes. In a telephone call between Southern Union, the Staff and the OPC on August 9, 2004, the Company stated that the value of the acquisition adjustment for this transaction is estimated to be approximately ** ___________ **

While the issue of rate recovery of acquisition adjustments is more significant in a case where a Missouri regulated utility is being acquired, it is still relevant in all acquisition cases involving Missouri companies. The Staff's concern in acquisition cases is addressed by the Company agreeing not to seek recovery of any acquisition adjustment in utility rates in Missouri. Staff included the following condition in the Stipulation:

> The amount of any asserted acquisition premium (i.e. the amount of the total purchase price and transaction above net book value) paid by Southern Union in connection with the transaction shall be treated below the line for ratemaking purposes in Missouri and not recovered in retail distribution rates. Southern Union shall not seek either direct or indirect rate recovery or recognition of any acquisition premium, including transaction costs, through any purported

> acquisition savings adjustment (or similar adjustment) in any future general ratemaking proceeding in Missouri. Southern Union reserves the right to seek Missouri rate recovery for internal payroll costs necessary to obtain Missouri regulatory approval of the Transaction, to the extent it can be clearly demonstrated that the savings achieved and allocated to MGE as a result of the Transaction are equal to or in excess of such costs. Other parties to any such proceeding shall not be precluded from opposing rate recovery of such costs, regardless of any asserted acquisition savings. In addition, Southern Union shall not seek to recover in Missouri the amount of any asserted acquisition premium in the Transaction as being a "stranded cost" regardless of the terms of any legislation permitting the recovery of stranded cost from Missouri ratepayers.

C. Financial Issues

Staff has continuously expressed concerns about the possibility that MGE ratepayers may end up paying for higher capital costs because of Southern Union's aggressive growth strategy. This was an issue as recently as the last MGE rate case, Case No. GR-2004-0209. In that case Southern Union's witnesses recommended an upward adjustment to the recommended rate of return for flotation costs, which are costs associated with the issuance of common equity when it was clear that the issuance of this common equity was needed because of Southern Union's increased leverage after its acquisitions. If Southern Union's credit rating were to fall below investment grade because of this transaction, even if Southern Union committed in this Stipulation not to pass along higher capital costs as a result of this event, Southern Union's proposals in past rate cases are not consistent with this commitment. It is possible that Southern Union might indirectly ask MGE ratepayers to pay for higher capital costs as a result of a downgrade in its credit rating to junk status. The Missouri regulated operations will not have caused this higher cost of capital, and Missouri ratepayers should not be asked to pay for this higher cost of capital.

Another risk with a possible downgrade of Southern Union's credit rating to below investment grade is the inability of Southern Union to refinance higher interest rate debt with lower interest rate debt if it would have been advantageous for them to do so.

1. Debts non-recourse

Consistent with the Panhandle transaction, the following condition was included:

> CCE and Successor Entities or any direct or indirect subsidiary of Southern Union that acquires or owns any equity interests in CrossCountry, will be owned and operated as a separate subsidiary of Southern Union. Southern Union shall not, directly or indirectly, allow any debt of CrossCountry or any of its subsidiaries, to be recourse to them; pledge Southern Union equity as collateral or security for the debt of CrossCountry or any of its subsidiaries; give, transfer, invest, contribute or loan to CrossCountry or any of its subsidiaries, any equities or cash without Commission approval. Southern Union shall not transfer to CCE and Successor Entities or any subsidiary thereof, directly or indirectly, assets necessary and useful in providing service to MGE's Missouri customers without Commission approval. Southern Union shall not enter, directly or indirectly, into any "make-well" agreements, or guarantee the notes, debentures, debt obligations or other securities of CrossCountry or any of its subsidiaries without Commission approval. Southern Union shall not adopt, indemnify, guarantee or assume responsibility for payment of, either directly or indirectly, any of the current or future liabilities of CrossCountry or any of its subsidiaries without Commission approval. Southern Union shall diligently exercise its best efforts to insulate MGE from any adverse consequences from its other operations or the activities of any of its affiliates. Southern Union shall submit reports its compliance with this paragraph 2 on a quarterly basis to Staff electronically through the Commission's Electronic Information System (EFIS) and to Public Counsel, and other interested parties that are subject to a Commission protective order until the Commission determines that MGE is insulated from Southern Union's other operations and the activities of any of its affiliates or that the requirement is no longer
> needed.

2. Cost of Capital:

Consistent with the Panhandle transaction, the following condition was included:

> Southern Union shall not recommend an increase, or claim Staff should make an adjustment to increase, the cost of capital for MGE as a result of the Transaction. Any increases in cost of capital Southern Union seeks for MGE will be supported by documented proof: (1) that the increases are a result of factors not associated with the Transaction; (2) that the increases are not a result of changes in business, market, economic or other conditions for MGE caused by the Transaction; or (3) that the increases are not a result of changes in the risk profile of MGE caused by the Transaction. Southern Union will ensure that the retail distribution rates for MGE ratepayers will not increase as a result of the Transaction. This condition that retail distribution rates for MGE ratepayers will not increase as a result of the Transaction means, among other things, that recovery of costs addressed by indemnification provisions of the Purchase Agreement will not be sought from MGE customers.

3. Budget conditions

To insure that MGE will have an adequate budget for its capital needs, Staff has obtained the commitment that:

> Southern Union will ensure that the Transaction shall have no adverse effect on MGE's budget and funds to meet MGE's capital needs, including but not limited to service line and main replacement programs. Southern Union remains committed to the safety line replacement program schedules for MGE currently in effect and approved by the Commission in its Case No. GO-2002-0050.

4. Ratemaking treatment

As a result of issues concerning rate making treatment that came up in the last MGE rate case, Case No. GR-2004-0209, the following condition is explicit in ratemaking consideration.

> 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, and that the Commission reserves the right to consider the rate making treatment to be afforded this transaction in any subsequent proceeding.

5. Creditworthiness

Southern Union's current credit rating at Standard & Poor's (S&P), Moody's and Fitch is BBB, Baa3 and BBB respectively. Both S&P and Moody's have Southern Union on a negative outlook, meaning if there is any movement in Southern Union's credit rating it will more likely be downward than upward. Staff is especially concerned about Moody's credit rating because it is only one notch above non-investment grade ("junk") status. Therefore, any movement downward by Moody's would result in a junk bond rating for Southern Union. Fitch currently has a stable outlook on Southern Union.

Because of the nature of the proposed transaction (Southern Union is not able to give Staff any assurance that the proposed transaction will be the transaction that is ultimately completed) Staff has included the following condition in the Stipulation:

> If CCE should decide to submit a higher offer for CrossCountry than the offer which is currently contemplated by the Purchase Agreement between CCE and Enron dated June 24, 2004 (the "Purchase Agreement") and this Application, then CCE's incremental amount offered over the currently contemplated purchase price of $2.35 billion shall be funded in a manner that results in a capital structure that is generally consistent with the proportional amounts of debt and equity as are presently defined in the Purchase Agreement, the Limited Liability Agreement, term sheet, and this Application. No less than 80% of Southern Union Company's investment in 50% of the equity interests of CrossCountry shall be funded with proceeds from the sale of Southern Union Company newly issued common stock. The other portion of Southern Union's investment in the 50% of the equity interests of CrossCountry shall be funded with proceeds from the sale of Southern Union MEDS Equity Units. To the extent that there is an incremental increase in the purchase price such that the purchase price

exceeds ** __________ ** billion, Southern Union shall be required to obtain additional approval from the Commission.

If CCE pays a higher price than that which is contemplated by this Application, then Southern Union must obtain another fairness opinion from J.P. Morgan and submit it to the Commission. If the higher price is not deemed to be fair, then the approval of this transaction is null and void.

If the terms of the Limited Liability Company Agreement of CCE Holdings and the attached LLC Term Sheet of CCE Holdings[2] (collectively, the "LLC Agreement"), the Joint Offer Letter and its attachments and/or the Purchase Agreement should materially change – beyond the potential change addressed in paragraph 11.A., above – which material change has a detrimental effect on MGE customers, then Southern Union shall be required to submit a new Application to the Commission to request approval of these changes.

That Southern Union shall not acquire any additional interest in CCE, whether financial or voting, until it files and receives approval to do so from the Missouri Public Service Commission.

Staff cannot guarantee that any or all of the credit rating agencies will not ultimately downgrade Southern Union's credit rating to junk status. In fact, even the credit rating agencies are reserving their final opinion until they can acquire more definitive information about the ultimate agreement and how the transaction will ultimately be financed. For example, S&P indicated the following in its June 25, 2004 press release regarding Southern Union's proposal to acquire an interest in CrossCountry:

> If Southern Union is ultimately the successful bidder for the assets, the rating impact will be determined after a review of the long-term prospects for the acquired pipelines' cash flows, as well as an analysis of the execution risks associated with integrating this large acquisition with Southern Union's existing pipeline assets.

[2] It is anticipated that the Limited Liability Company Agreement of CCE Holdings and the attached LLC Term Sheet of CCE Holdings shall be combined into one complete Limited Liability Agreement of CCE Holdings and to the extent this combination is considered a change, it is not material.

Because of this situation Staff has been unable to get any verbal comments from credit ratings agencies such as Standard and Poor's (S&P). Staff contacted S&P on August 12, 2004 to determine if S&P could provide Staff with any further insight on the proposed transaction, but S&P was not forthcoming with additional information for confidentiality reasons. The nature of this transaction has caused Staff to have difficulties obtaining information that may address Staff's concerns about the possibility that Southern Union's credit rating may fall below investment grade. Staff can usually get assurances from third parties when Staff is attempting to evaluate the impact of a purchase by a utility on that company's operations.

Because Staff has not been able to receive some assurance from the credit rating agencies that Southern Union's credit rating will not fall below investment grade as a result of this transaction, Staff has attempted to simulate what the credit rating agencies might do by trying to evaluate the effect that this transaction may have on Southern Union's financial ratios. S&P publishes benchmarks on three main financial ratios: debt to total capital, funds flow from operations to debt (FFO/debt) and funds flow from operations to interest (FFO/interest). Comparison of Southern Union's ratios to these benchmarks would by no means be a comprehensive credit analysis, but this comparison would give Staff at least some idea as to the effect the transaction may have on Southern Union's credit quality.

Staff also compared the 2003 consolidated pro forma ratios provided by the Company to Southern Union's 2003 stand-alone ratios in order to determine if these ratios would deteriorate more than they did after the Panhandle Energy operations were included in the 2003 financial statements. Staff made similar comparisons for the 2004 pro forma consolidated and stand-alone financial information provided by Southern Union (please see Attachments B and C). In order to gain some comfort that these financial ratios were accurate and reliable, Staff had discussions with Southern Union personnel in order to ensure that Southern Union's ratios were calculated consistent with S&P's methodology.

Staff reviewed a fairly conservative financing scenario in which Southern Union would finance at least 80% of the equity contribution with newly-issued Southern Union common stock, which is the minimum amount of common equity that Southern Union committed to issue in the aforementioned condition, and 20% of MEDS Equity Units. The scenario further assumed that Southern Union would finance the remainder of the purchase price with debt at both/either the CCE level and/or the Transwestern Pipeline level. This scenario also assumed that 50% of CCE's financials were consolidated with Southern Union's financial statements even though the transaction has been structured to be able to employ the equity method of accounting.

Attachment B shows the 2003 comparisons, which is probably the better scenario to illustrate the relative impact of the transaction because other than excluding the non-recurring tax item in Transwestern's 2003 Income Statement, it reflects actual results for 2003. A review of attachment B indicates that both the Funds From Operations Interest Coverage ratio and the Funds From Operations to Total Debt deteriorate slightly when showing the pro forma effects of the CrossCountry acquisition. However, these ratios are still slightly above the lower ends of the S&P benchmarks for a "BBB" rating. Total Debt to Total Capital actually shows a slight improvement. This is because the transaction is being financed with a less leveraged capital mix than Southern Union's capital structure at the end of 2003. Although this ratio is greater (worse) than the S&P benchmark for a "BBB" rating, it is shows less debt leverage than after the Panhandle transaction. Because it does not appear the completion of this transaction will cause Southern Union's coverage ratios to deteriorate much from Southern Union's actual ratios in 2003 and the capitalization ratio actually shows improvement, Staff is fairly comfortable that

Southern Union will not be downgraded to below investment grade status as a result of the financing of this transaction. This is primarily because even with Southern Union's strained ratios after it acquired Panhandle in 2003, it remained investment grade. However, Staff does remain concerned that Southern Union did not allow for much reduction of its financial risk before consummating this transaction. However, this, at least in part, appears to be one of the reasons that Southern Union structured this transaction as a joint venture with GE.

Staff has also attempted to discuss other possible safeguards that may mitigate the possibility that additional business risk may cause Southern Union's credit rating to fall to junk. Staff is concerned about Southern Union's exposure to additional business risk because of Southern Union's consistent exposure to a high amount of financial risk, i.e. debt leverage in the capital structure. Staff recognizes that Southern Union's dividend policy of not paying a cash dividend, but a stock dividend, is advantageous in that Southern Union retains its earnings instead of paying it out in cash. However, Southern Union has not shown this policy will allow it to improve its capital structure. It appears that this dividend policy is also driven by Southern Union's desire to acquire additional businesses in the future.

This is the reason that Staff has adopted the following condition:

> Southern Union shall not, either directly through Southern Union itself or indirectly through any division, affiliate or subsidiary, expand its activities with respect to the operation of an energy marketing and trading business without approval from the Commission, which approval shall not be unreasonably withheld.
>
> Staff evaluated the possible impact of this transaction on Southern Union's creditworthiness. Staff's evaluation relied heavily upon Southern Union's representation that it intends to maintain its investment grade credit rating and currently does not intend to diversify outside of natural gas transmission and distribution operations. Any diversification outside of these operations may, in the Staff's opinion, entail more business risk for Southern Union. An increase in Southern Union's business risk may, in the Staff's opinion, require the Company to make a related reduction to its financial risk (e.g. lower its debt leverage) in

order to maintain an investment grade credit rating. If Southern Union decides to engage in lines of business with additional business risk in the future, then the debt capital that MGE may, in the Staff's opinion, have to rely upon for capital investments could be subjected to loss of investment-grade status. Such decisions are outside of Staff's control. Southern Union does not agree with or acquiesce to the foregoing Staff opinions.

6. Indemnification

The purchase agreement between CCE Holdings, LLC, Enron Operations Services, LLC, Enron Transportation Services, LLC, EOC Preferred, LLC, and Enron Corporation identify indemnifications by the sellers and the purchaser. The complexity of the transaction includes the Enron bankruptcy cases, potential pension fund liabilities, environmental liabilities, personal injury claims, etc. While Southern Union may choose to indemnify the seller and assume the risk of some potential future costs ** ____ ______________________________, ** Staff would not support inclusion of any of these potential CCE Holdings indemnification costs in Missouri rates. The Staff has required the following condition that Southern Union not be permitted to seek recovery in its Missouri retail rates, costs or liability expenses associated with CCE Holdings property or other assets that arise from events or activities occurring:

> Southern Union will ensure that the retail distribution rates for MGE ratepayers will not increase as a result of the Transaction. This condition that retail distribution rates for MGE ratepayers will not increase as a result of the Transaction means, among other things, that recovery of costs addressed by indemnification provisions of the Purchase Agreement will not be sought from MGE customers.

7. Corporate allocation issues

The Staff is concerned with MGE receiving an inappropriate share of Southern Union's corporate overhead costs (also referred to as joint and common costs) as a result of this acquisition. Southern Union stated in its Application that "total joint and common costs allocated to Missouri for purposes of setting retail distribution rates will not increase as a result of the Transaction above the levels proposed by MGE in Case No. GR-2004-0209. In response to Staff DR 34, Southern Union stated that total joint and common costs allocated to MGE in Case No. GR-2004-0209 amounted to $2,925,061 (82.6733% expense capital ratio).

While the acquisition of CrossCountry should result in significantly less corporate allocations to MGE, this commitment by Southern Union at least provides a ceiling on the level of corporate cost allocations to MGE it will seek in its next rate case. To mitigate the Staff's concerns on the impact of the CrossCountry acquisition on the overall level of MGE's corporate cost allocations, the Staff has agreed to the following condition:

> Total joint and common costs allocated to Missouri for purposes of setting retail distribution rates shall not increase as a result of the Transaction above the latest levels proposed by MGE in its true-up filing in Case No. GR-2004-0209 (EFIS Item Number 305, Corrected True-Up Testimony of Michael R. Noack, July 20, 2004).

The Staff has also reviewed the proposed acquisition and its effects on corporate cost allocations to determine if Southern Union can demonstrate that it will, subsequent to this acquisition, allocate corporate overhead costs to MGE on a fair, reasonable and justifiable basis.

The Staff felt it was necessary to include the following conditions to 1) resolve the concern that the allocation of corporate overhead costs to CrossCountry be consistent with the method and formulas Southern Union uses to allocate costs to its other business units, 2) ensure the provision of documentation to the Staff to demonstrate compliance with the Commission's affiliate transactions rules and 3) to ensure the provision of documentation in any future rate case to demonstrate the reasonableness of corporate cost allocations:

> For purposes of allocating joint and common costs, CrossCountry will be treated much the same as Southern Union agreed to treat Panhandle in Case No. GR-2004-0209. Southern Union must allocate corporate costs based on factors that faithfully and accurately represent, to the greatest extent possible, the level of actual corporate involvement in the corporate services provided and the actual business unit beneficiaries of the incurred costs. Southern Union further agrees that it will not limit the amount of corporate overhead costs allocated to any business unit based on artificial factors, including but not limited to the percentage of equity ownership, but on substantive cost causation factors.
>
> Southern Union agrees that within six (6) months of the closing of the Transaction, it shall perform, provide, and discuss with all interested parties subject to a Commission protective order a study of the impact of the acquisition and operation of CrossCountry and its Successor Entities on Southern Union's structure, organization, and costs. Specifically, Southern Union will immediately upon providing the study (to be submitted in EFIS), meet with Staff to provide supporting details to enable Staff to verify the accuracy of corporate administrative and general ("A&G") allocations to MGE. This study will address the specific impacts of the acquisition and operation of CrossCountry and its Successor Entities on Southern Union's A&G expense and cost allocation methodology. Southern Union will specifically identify the process used to allocate A&G costs and expenses to its regulated, merger and acquisition, sale and non-regulated functions of its regulated divisions as well as its non-regulated subsidiaries. If Southern Union decides not to retain merger and acquisition costs (including acquisition adjustments, transaction costs, transition costs and a reasonable allocation of corporate employee payroll and benefits) at the corporate level, it shall provide to the Staff and OPC all the data in which to make a reasonable allocation of these costs to the corporate office cost center (i.e. retained at the corporate level). Southern Union agrees that it will make its best effort to provide to the Staff and OPC all direct and indirect costs of its merger and acquisition activities.
>
> Southern Union agrees that the types and availability of raw data necessary to perform allocations of corporate overhead costs to be used in the study will include all data required to calculate the A&G allocations (e.g. an allocation factor based upon revenues will include the revenue amount of each entity and the cumulative revenues used to calculate the percentage to be allocated to each entity to which the factor is being applied) and the source of the data (e.g. financial statement for the fiscal year ending.) The raw data to be discussed shall include, but not be limited to, regulated and non-regulated information concerning customer numbers and billing information, revenue data, asset information (gross and net plant, etc.), management work time allocations, employee numbers and

> other payroll data, and the Missouri jurisdictional rate of return on investment ("ROR") and return on equity ("ROE").
>
> The allocation procedures to be disclosed shall include, but need not be limited to: the use of cost allocation manuals, timesheets, time studies, and/or other means of tracking and allocating costs. The allocation procedures provided in the study and further discussed with Staff shall provide a means to identify and substantiate the portions of each individual corporate employee's time and associated payroll cost being allocated to Southern Union's regulated divisions.

D. Accounting issues

CrossCountry would be the first of Southern Union's many utility acquisitions recorded using the equity method of accounting. The equity method is generally used for investments in common stock where the investor owns more than 20 percent but less than 51 percent of the outstanding voting stock.

With the equity method of accounting Southern Union will only show one item on its balance sheet (Equity Investment in CrossCountry) and one item on the income statement (Other Income - earnings from CrossCountry). Under the consolidation method, however, all of CrossCountry's balance sheet accounts (assets, liabilities and equity) and income statement accounts (revenues, expenses, gains and losses) would be reflected in all of Southern Union's balance sheet and income statement accounts.

A common motivation for structuring a transaction to use the equity method as opposed to the consolidation method of accounting is to keep debt off the balance sheet. With less debt, companies may appear less risky. Also, by keeping debt off of the balance sheet, companies are able to maintain compliance with bond covenants, such as the interest coverage ratio (earnings before interest and taxes divided by interest expense).

At the August 9, 2004 meeting, Southern Union stated that it structured the transaction to acquire a 50 percent equity ownership in CrossCountry in order to use the equity method of accounting. Although the equity method usually results in the same net income and the same net assets as consolidation, the equity method omits significant revenues and expenses from the income statement, omits significant assets and liabilities from the balance sheet, and omits significant receipts and payments from the statement of cash flows.

The Staff has little or no experience with transactions such as this one being structured to use the equity method of accounting. The Staff did have initial concerns about the lack of audited financial information on Southern Union's financial statements as a result of using the equity method. In addition, the Staff had concerns that Southern Union would try to use the form of the accounting of this transaction as support for its position on revenue requirement issues in subsequent MGE rate cases. The Staff, however, has become satisfied that, given the following conditions agreed to by Southern Union, in addition to the conditions on corporate cost allocations, that the use of the equity method of accounting will not have a detrimental impact of the operations of MGE:

> If Southern Union records the acquisition of CrossCountry using the equity method of accounting, this election by Southern Union shall not be used as a primary basis or supporting basis for the ratemaking treatment of any revenue requirement issue in MGE's subsequent rate cases.
>
> Following the closing of this Transaction, Southern Union shall submit to the Staff a copy of a letter from its outside independent auditor describing the type of accounting it believes to be appropriate for this transaction, given all the terms and conditions of the transaction, and the specific generally accepted accounting principles it relied upon in reaching this conclusion. It is not intended that this condition cause Southern Union to obtain such a letter any earlier than would normally occur in the normal course of events. If Southern Union obtains such a letter prior to closing of the Transaction, it will be provided to the Staff and OPC.

E. Affiliate Transactions

Staff and Southern Union have agreed to permit Staff to have access to information that Staff believes necessary to determine whether Southern Union is in compliance with the

Commission's affiliate transactions rules. Staff does not believe that it is in the interests of Missouri ratepayers to have access to information concerning either corporate allocations or other affiliate transactions limited. Staff's conditions identify the specific types of raw data that Southern Union will maintain related to affiliate transactions and corporate allocation of costs between the divisions and nonregulated operations of Southern Union. The retention of raw data will provide the documentation to support the affiliate transactions and corporate allocation of costs between the divisions and nonregulated operations of Southern Union. This will allow Staff to audit Southern Union's compliance with the Commission's affiliate transactions rules. The conditions that support Staff's access to the raw data and supporting information of Southern Union are also applicable to corporate allocation issues and have been included above. Staff also recommends the following conditions:

> A. Southern Union shall retain all documentation relative to the analysis of the Transaction and all merger, acquisition, and sale activity that has occurred since May 1, 2004. This documentation will include a list of: (1) all Southern Union and MGE personnel, consultants, legal and financial and accounting advisers; (2) the time (in hours) spent by those individuals on related work; (3) other expenses, costs or expenditures incurred or recognized by Southern Union that are related to the Transaction; (4) business entity (corporate, subsidiary and division) where the costs were booked, including account number, account description and amount; and (5) description of the nature of the work performed and costs incurred.
>
> Southern Union shall maintain its books and records so that all acquisition costs (including the Transaction and future Southern Union merger and acquisition transactions) are segregated and recorded separately. During MGE's next general rate proceeding, Southern Union agrees to disclose to the Staff, OPC, and other interested parties subject to a Commission protective order acquisition, merger, transition, and transaction costs recorded in Southern Union's books and records in the appropriate test year. Upon request by the Staff or OPC, Southern Union also agrees to disclose this information as it relates to affiliated transactions and allocation factors to be included in its annual report to the Commission as required by the Affiliated Transactions Rules.
>
> This condition does not restrict Southern Union's right to seek rate recovery of merger and acquisition costs related to future transactions. Other parties to this proceeding may oppose recovery of merger and acquisition costs related to future transactions. Southern Union agrees to create and maintain

records listing the names of Southern Union employees, number of hours worked, type of work performed and travel and other expenses incurred for all work related to all merger and acquisition activities and specifically to CrossCountry through the end of the test year, updated test year or true-up test year in MGE's next general rate case. Upon request by the Staff or OPC, Southern Union also agrees to disclose this information as it relates to affiliated transactions and allocation factors reported annually to the Commission under the Affiliated Transactions Rules. Southern Union will submit to the Commission's Staff electronically in EFIS as a filing to this case and to OPC verified journal entries reflecting the recording of the Transaction and all other merger, acquisition since May 1, 2004 of Southern Union's books and records within forty-five (45) days of closing.

B. Southern Union shall provide the Staff and OPC with access, upon reasonable written notice during normal working hours and subject to appropriate confidentiality and discovery procedures, to all written information provided to common stock, bond, or bond rating analysts, which directly or indirectly pertains to Southern Union or any affiliate that has affiliate transactions with MGE or with Southern Union to the extent such transaction(s) with Southern Union affect the allocation of costs to MGE. Such information includes, but is not limited to: reports provided to, and presentations made to, common stock analysts and bond rating analysts. For purposes of this condition, "written" information includes but is not limited to: any written and printed material, audio and videotapes, computer disks and electronically stored information. Nothing in this condition shall be deemed to be a waiver of Southern Union's or MGE's right to seek protection of the information or to object, for purposes of submitting such information as evidence in any evidentiary proceeding, to the relevancy or use of such information by any party.

C. Upon request, MGE and Southern Union agree to make available to Staff and OPC, upon written notice during normal working hours and subject to appropriate confidentiality and discovery procedures, all books, records and employees of Southern Union, MGE and its affiliates as may be reasonably required to verify compliance with the conditions set forth in this Stipulation and Agreement. MGE and Southern Union shall also provide Staff and OPC any other such information (including access to employees) relevant to the Commission's ratemaking, financing, safety, quality of service and other regulatory authority over MGE; provided that MGE and any affiliate or subsidiary of Southern Union shall have the right to object to such production of records or personnel on any basis under applicable law and Commission rules, excluding any objection that such records and personnel of affiliates or subsidiaries; (a) are not within the possession or control of MGE; or (b) are either not relevant or are not subject to the Commission's jurisdiction and statutory authority by virtue of or as a result of the implementation of the proposed acquisition.

Conclusion

In consideration of the Non-Unanimous Stipulation and Agreement filed by Staff and Southern Union, and for the reasons stated in this Memorandum, Staff asks the Commission to approve the Non-Unanimous Stipulation and Agreement.

Respectfully submitted,

DANA K. JOYCE
General Counsel

/s/ Thomas R. Schwarz, Jr.

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Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, or transmitted by facsimile or electronic mail to all counsel of record this 26th day of August, 2004.

/s/ Thomas R. Schwarz, Jr.