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February 14, 2003

FILED³

FEB 14 2003

Missouri Public
Service Commission

Mr. Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge
Missouri Public Service Commission
P.O. Box 360
Jefferson City, MO 65102

**Re: Southern Union Company d/b/a Missouri Gas Energy
Case No. GM-2003-0238**

Dear Mr. Roberts:

On behalf of Southern Union Company, I deliver herewith an original and eight (8) copies of:

- **Direct Testimony of Thomas F. Karam;**
- **Direct Testimony of David J. Kvapil (HC); and**
- **Direct Testimony of David J. Kvapil (Nonproprietary) (original only)**

for filing with the Commission in the referenced matter. I would appreciate it if you would see that the copies are distributed to the appropriate Commission personnel. Service copies have been mailed or hand-delivered this date.

Please be advised that originals of the affidavits of both witnesses will be late-filed for substitution for the facsimile copies that are affixed to the testimony.

I have also enclosed an extra copy of each document which I request that you stamp "Filed" and return to the person delivering them to you.

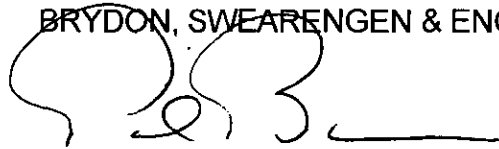
Thank you for your attention in this matter.

Mr. Dale Hardy Roberts
February 14, 2003
Page 2

Sincerely,

BRYDON, SWEARENGEN & ENGLAND P.C.

By:

A handwritten signature in black ink, appearing to read 'PAB', followed by a horizontal line.

Paul A. Boudreau

PAB/ccp
Enclosures
cc: All parties of record

FILED³

FEB 14 2003

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

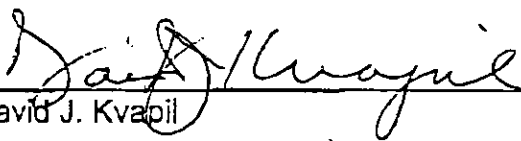
Missouri Public
Service Commission

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 One Hundred Percent)
(100%) of the Equity Interests of Panhandle)
Eastern Pipeline Company, Including Its)
Subsidiaries, and to Take All Other Actions)
Reasonably Necessary to Effectuate Said)
Transaction.)

Case No. GM-2003-0238

AFFIDAVIT OF DAVID J. KVAPIL

David J. Kvapil, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Direct Testimony of David J. Kvapil;" that said testimony and schedules attached hereto were prepared by him and/or under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge, information and belief.


David J. Kvapil

State of Pennsylvania
County of Luzerne

SUBSCRIBED and sworn to before me this 14th day of February, 2003


Notary Public

Notarial Seal
Bonny M. Nallon, Notary Public
City of Wilkes-Barre, Luzerne County
My Commission Expires June 1, 2006

Member Pennsylvania Association of Notaries

Exhibit No.:
Issue: Purchase of Equity Interests
of Panhandle Eastern Pipeline
Company
Witness: David J. Kvapil
Type of Exhibit: Direct Testimony
Sponsoring Party: Southern Union Company
d/b/a Missouri Gas Energy
Case No.: GM-2003-0238
Date Testimony Prepared: February 14, 2003

FILED³

FEB 14 2003

Missouri Public
Service Commission

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

CASE NO. GM-2003-0238

DIRECT TESTIMONY

OF

DAVID J. KVAPIL

FEBRUARY, 2003

MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. GM-2003-0238

DIRECT TESTIMONY OF DAVID J. KVAPIL

1 **Q. Please state your name and business address.**

2 A. My name is David J. Kvapil. My business address is One PEI Center, Wilkes-
3 Barre, Pennsylvania 18711.

4 **Q. By whom are you employed and in what capacity?**

5 A. I am the Executive Vice President and Chief Financial Officer at Southern Union
6 Company ("Southern Union" or the "Company"). In that position, I am
7 responsible for capital-market financing, debt and cash management, investor
8 relations, financial accounting and reporting, taxation, and information
9 technology.

10 **Q. Please briefly summarize your educational and professional background.**

11 A. I have a Bachelor of Arts degree from St. Mary's University of San Antonio and a
12 Master of Science in Accounting from Texas A&M University. I am also a
13 Certified Public Accountant. I have been employed by Southern Union since
14 1992 and have held various positions including Controller, Vice President and
15 Senior Vice President. I have been the Executive Vice President and Chief
16 Financial Officer since October 2001.

17 **Q. Would you please provide a brief description of the Company?**

18 A. Southern Union is a Delaware corporation that is primarily involved in the
19 distribution of natural gas as a public utility to approximately 1.0 million
20 customers through its operating divisions in Missouri, Pennsylvania, Rhode
21 Island, and Massachusetts. On October 16, 2002, Southern Union announced that

1 it had entered into an agreement to sell its Texas operating division (serving
2 approximately 541,000 customers) to ONEOK, Inc. The transaction closed in
3 early January 2003, following clearance by the Federal Trade Commission
4 ("FTC") and approval by certain Texas municipalities. The Company also
5 currently serves approximately 498,000 customers through its operations in
6 Missouri (Missouri Gas Energy), 157,000 customers through its operations in
7 Pennsylvania (PG Energy) and 295,000 customers in Rhode Island and
8 Massachusetts (New England Gas Company).

9 **Q. What is the scope of your testimony?**

10 A. I am testifying in support of the Company's Application for authority to acquire,
11 through its wholly-owned subsidiary, Southern Union Panhandle Corp.
12 ("SUPC"), a Delaware corporation, the equity interests of Panhandle Eastern Pipe
13 Line Company ("Panhandle Eastern"), which is currently owned by the CMS Gas
14 Transmission Company ("CMS").

15 **Q. Please provide a summary of the transaction that will be undertaken to**
16 **accomplish SUPC's acquisition of the equity interests of Panhandle Eastern**
17 **pipeline facilities.**

18 A. Over the past year, events in the energy industry have created significant growth
19 opportunities for energy companies that remain economically viable and possess
20 the expertise to manage assets that are now available in the marketplace. The
21 Company recognizes that these opportunities have the potential to produce
22 significant value for both customers and shareholders in terms of increasing

1 operating margins, improving the overall financial position of the Company and
2 allowing for a more cost-effective use of internal resources.

3 In an effort to capitalize on the opportunities created by recent industry events,
4 Southern Union has entered into an arrangement with AIG Highstar Capital, L.P.
5 ("AIG Highstar") and AIG Highstar II Funding Corp. ("AIG Funding"), a private
6 equity fund sponsored by American International Group, Inc., to acquire an equity
7 interest in SUPC, which will purchase the interstate-pipeline operations of
8 Panhandle Eastern.

9 Pursuant to the terms of a Stock Purchase Agreement, SUPC will acquire from
10 CMS all of the issued and outstanding shares of Panhandle Eastern. The total
11 consideration to be paid by SUPC for these shares is approximately \$662.3
12 million in cash, plus generally any increase in net working capital from that as of
13 September 30, 2002 (or minus any such decrease), less any increase in total debt
14 from that as of September 30, 2002 (or plus any such decrease). In addition,
15 SUPC will assume the debt of Panhandle Eastern at closing, which is estimated to
16 be approximately \$1.17 billion. For Southern Union, this debt is non-recourse
17 debt, which means that the debt is not in any way guaranteed by Southern Union.

18 For federal income tax purposes, the transaction will be structured as a "like-kind
19 exchange" with the shares first transferred to a qualified intermediary and then
20 from the intermediary to SUPC (or another entity in which Southern Union owns
21 all of the voting securities). AIG Highstar and AIG Funding will have, post-
22 closing, the right to acquire a non-voting equity interest in SUPC. Neither AIG

1 Highstar nor AIG Funding will have any voting shares of SUPC, any rights to
2 name members of the Board of Directors of SUPC, or any rights to have an
3 observer at board meetings of SUPC. Nor will AIG Highstar or AIG Funding
4 have any right to participate in ordinary course management decisions of SUPC.

5 Among other prerequisites, this transaction is conditioned upon the expiration or
6 early termination of the applicable waiting period under the Hart-Scott-Rodino
7 Antitrust Improvements Act of 1976, as amended, and various state regulatory
8 approvals. The parties intend to close the transactions as soon as practicable after
9 all consents and approvals have been obtained.

10 **Q. Please describe the investment that Southern Union will make to complete**
11 **the transaction and acquire an equity interest in SUPC.**

12 A. To complete this transaction, Southern Union will invest up to \$512 million in
13 SUPC, which will be jointly owned by Southern Union (approximately 77.9
14 percent) and AIG Highstar (approximately 22.1 percent). AIG Highstar will
15 invest up to \$150 million to accomplish the transaction. For reasons discussed
16 below involving a guarantee of the performance of AIG Funding and the
17 requirements of a like-kind exchange, Southern Union is requesting approval to
18 invest up to a total of \$662.3 million, although the net investment with AIG's
19 participation will be in an amount less than \$662.3 million.

20 **Q. Please describe the operations of Panhandle Eastern.**

21 A. Panhandle Eastern is a "natural gas company" as defined in section 2 of the
22 Natural Gas Act (15 U.S.C. § 717) and, with reference thereto, is subject to all

1 applicable rules and regulations promulgated by the Federal Energy Regulatory
2 Commission ("FERC"). Panhandle Eastern is engaged in the interstate
3 transportation and storage of natural gas and the storage and re-gasification of
4 liquefied natural gas ("LNG"). Panhandle Eastern operates a network of almost
5 11,000 miles of mainline natural gas pipeline facilities extending from the Gulf of
6 Mexico to the Midwest United States and Canada. The Panhandle Eastern
7 pipeline facilities provide access to the major natural gas supply regions located
8 on the Gulf Coast in Louisiana and Texas, as well in the mid-continent and Rocky
9 Mountains.

10 The seller in this transaction, CMS, is a subsidiary of CMS Energy Corporation,
11 which has owned and operated Panhandle Eastern since 1999, when it purchased
12 the company from Duke Energy Corporation for approximately \$1.9 billion in
13 cash and the assumption of \$300 million in debt.

14 **Q. Please describe the operations of AIG and AIG Highstar.**

15 A. AIG Highstar is a sector-specific private equity fund that invests in businesses
16 within the power, transportation and environmental markets. The fund is
17 sponsored by AIG, which is the world's leading international insurance and
18 financial services organization. AIG Highstar is managed by AIG Global
19 Investment, Corp. Like Southern Union, AIG Highstar believes that the purchase
20 of Panhandle Eastern is an attractive investment opportunity given its book value
21 and stable customer base.

1 **Q. Please discuss the plan for managing the operations of SUPC.**

2 A. The day-to-day management and operations of SUPC will continue to be
3 conducted by employees of the Panhandle Eastern companies. Southern Union
4 will provide various corporate services including treasury, risk management, and
5 employee-benefit administration. Lastly, pursuant to the terms of the Stock
6 Purchase Agreement, Southern Union will own all of the voting common stock of
7 SUPC, which means that the Company will assume control over the
8 implementation of all ordinary course operating and financial decisions.

9 **Q. How will the acquisition by Southern Union of the equity interests of**
10 **Panhandle Eastern be beneficial for the Company, and ultimately, the**
11 **customers of Southern Union's local gas distribution operations?**

12 A. The Company's financial analysis shows that the acquisition of the equity
13 interests of Panhandle Eastern will generate earnings, cash flow and potential
14 financial and operating synergies that will significantly strengthen the Company's
15 financial position. As the Commission is aware, Southern Union recently
16 divested its Texas operations. In this transaction, Southern Union is acquiring an
17 equity interest in a business entity that is roughly four times the size of the Texas
18 facilities in terms of asset value. This transaction will significantly improve the
19 Company's revenue stream (and net earnings), and in combination with the
20 issuance of common and/or preferred stock (which will be discussed later in my
21 testimony), will place the Company in a strong financial position. Ultimately, this
22 will benefit customers in terms of the Company's ability to attract capital at

1 optimal rates, to maintain cash flows, to maintain stable interest rates and to
2 provide a high level of customer service.

3 For example, the Company's analysis shows that estimated operating revenues for
4 FY 2004, the first full year of operation following the investment, will increase by
5 over 20 percent. Also in FY 2004, net earnings before interest, taxes,
6 depreciation and amortization ("EBITDA") are estimated to increase by over 70
7 percent as compared to the Company's actual earnings in FY 2002. The per-share
8 book value of the Company is projected to increase by approximately 10 percent.
9 A copy of a financial statement showing the *pro forma* financial effect of the
10 transaction is attached as "Schedule DJK-1 (HC)" to my testimony. In any event,
11 customers of the local gas distribution companies will benefit from the enhanced
12 financial position of the Company and the resulting ability to attract capital and
13 finance operations at the optimal cost.

14 **Q. Are there any other beneficial aspects of the arrangement that Southern**
15 **Union will enter into with AIG Highstar to acquire the equity interests of**
16 **Panhandle Eastern?**

17 **A.** Yes. The arrangement with AIG Highstar would allow Southern Union to
18 substitute the Texas local gas distribution operations with the Panhandle Eastern
19 interstate pipeline operations through a "like-kind exchange" of property pursuant
20 to Section 1031 of the Internal Revenue Code of 1986, as amended. By
21 structuring the transaction as a like-kind exchange, Southern Union will be
22 allowed to defer approximately \$100 million of federal tax liability that would

1 otherwise be payable upon the divestiture of the Texas operations. This
2 represents a substantial cash source for the Company and will enable the
3 Company to maintain and build upon the value realized since the acquisition of
4 the Texas property.

5 **Q. Will the operation of SUPC have any negative effect on the Company's**
6 **ability to manage its local gas distribution activities?**

7 A. No. For several reasons, the SUPC operations will have no negative effect on the
8 Company's ability to manage its local gas distribution activities. First, as
9 interstate-pipeline facilities, the SUPC operations will be fully regulated by the
10 FERC as they have been in the past when operated by Panhandle Eastern. In that
11 regard, the SUPC facilities have a record of safe and reliable operation under the
12 management of Panhandle Eastern. In addition, Southern Union will manage the
13 activities of SUPC as a separate subsidiary with designated personnel and
14 resources.

15 Over the past two years, Southern Union has decentralized its operations and
16 established local business units with strong management teams that function
17 independently, except with respect to certain financial and corporate-management
18 activities that are performed at the corporate level. Thus, in terms of internal
19 resources, Southern Union is essentially substituting the interstate pipeline
20 facilities for the local gas distribution operations that Southern Union has been
21 conducting in Texas, and therefore, the transaction would have no negative effect
22 on customers of the distribution companies operated by Southern Union. In fact,
23 customers are fully protected from any possible negative ramifications because

1 their rates will not change as a result of the Commission's approval of the
2 investment and, in the future, cannot change without Commission approval. In
3 addition, the quality of service provided to customers in Missouri is tracked and
4 monitored through a service-quality program that may subject the Company to
5 specified financial penalties in the event that performance criteria are not met.

6 At the same time, the addition of the SUPC operations is expected to enhance the
7 financial operations of the Company, which would benefit the customers of the
8 Company's distribution companies in terms of access to capital markets and the
9 Company's cost of capital. Moreover, as a result of the addition of the SUPC
10 operations, Southern Union will have the opportunity to achieve financial and
11 operating synergies that will help to reduce costs for the overall system. These
12 potential synergies would not be available to customers in the absence of the
13 SUPC arrangement. As a result, Southern Union will be better positioned to
14 continue to maintain stable rates for Missouri customers on a going-forward basis.
15 For these reasons, customers bear no risk and can only benefit from the proposed
16 investment.

17 **Q. Please describe how the Company intends to fund its interest in SUPC.**

18 A. As noted above, Southern Union and AIG Highstar have entered into an
19 arrangement to acquire the interstate-pipeline distribution operations of Panhandle
20 Eastern for approximately \$662.3 million. Of this amount, AIG Highstar will
21 invest approximately \$150 million and Southern Union will invest approximately
22 \$512 million. Southern Union will fund its portion of the purchase price

1 primarily with the cash proceeds generated from the sale of its Texas operations
2 (approximately \$420 million). The remainder of the purchase price, up to
3 approximately \$100 million (assuming an investment of \$150 million by AIG
4 Highstar), will be funded by Southern Union using available resources, including
5 short-term debt. However, to maintain a balanced capital structure following the
6 purchase (through the repayment of long-term debt) and to fund utility operations
7 without raising debt levels, the Company will be issuing common and/or preferred
8 stock up to an approximate aggregate value of \$300 million.

9 **Q. For what purpose is Southern Union issuing additional shares of common**
10 **and preferred stock?**

11 A. The Company recognizes that there is a need to maintain a more favorable debt-
12 to-equity ratio through the repayment of long-term debt and the issuance of
13 additional equity following the completion of the Panhandle Eastern acquisition.
14 Accordingly, the proceeds from the stock issuance will be used for a number of
15 purposes, including the repayment of long-term debt, the redemption of existing
16 preferred securities and the funding of utility operations in order to maintain and
17 enhance the Company's financial position. These activities are consistent with
18 the company's utility-service obligations.

19 **Q. As part of the transaction, does the Company make any financial guarantees**
20 **on behalf of any entity?**

21 A. Yes. As noted in Section 5.19 and other relevant provisions of the Stock Purchase
22 Agreement Southern Union has agreed to "guarantee" the performance of AIG
23 Funding, which together with Southern Union is responsible for providing up to

1 96.3 percent of the purchase price. This guarantee is a necessary component of
2 the overall transaction because it enables and maintains the like-kind exchange
3 under the IRS rules. Although it is the intent of the parties to accomplish the
4 transaction with an investment by AIG Highstar of approximately \$150 million at
5 closing, to qualify as a like-kind exchange under the IRS rules, the Company must
6 be the (initial) purchaser of 100 percent of the equity interest associated with
7 Panhandle. Moreover, Southern Union's guarantee of performance by AIG
8 Funding is consistent with general practice in joint venture transactions where one
9 partner typically ensures the seller that funding will be available to complete the
10 sale. Here, Southern Union is providing a guarantee of the financial performance
11 of AIG Funding primarily to enable the like-kind exchange, but also to assure the
12 seller that the transaction will be completed. This guarantee is a perfunctory
13 component of the overall transaction.

14 In requesting authorization to acquire all of the equity interests of Panhandle
15 Eastern, the Company has addressed the circumstance of a reduced level of
16 participation by AIG Highstar (through AIG Funding). The Company is
17 requesting such approval because it is necessary to complete the transaction
18 should AIG Highstar and AIG Funding not perform their portion of the
19 acquisition, or AIG Highstar or AIG Funding and Southern Union are not able to
20 finalize terms for AIG Highstar's or AIG Funding's participation in the purchase
21 and continued ownership of Panhandle Eastern.

1 **Q. What is the anticipated closing date for the purchase of the Panhandle**
2 **Companies?**

3 A. Southern Union is hopeful that it will be able to close the purchase of Panhandle
4 Eastern on or before March 15, 2003, pending the completion of the regulatory
5 approval processes involved in the transaction. To complete the transaction,
6 Southern Union must receive clearance from the Federal Trade Commission (the
7 “FTC”), pursuant to Section 201 of the Hart-Scott-Rodino Antitrust
8 Improvements Act of 1976 (“HSR Act”). Generally, under the HSR Act, the
9 parties to the acquisition must complete a 30-day waiting period pending
10 clearance by the FTC and the Antitrust Division of the Department of Justice.
11 CMS and Southern Union refiled for HSR review on February 11, 2003.

12 **Q. Has regulatory approval been sought from any state regulatory agency other**
13 **than the Commission?**

14 A. Yes. The Company is seeking approval of the transaction from the Massachusetts
15 Department of Telecommunications and Energy (the “Department”). The
16 Company expects the Department’s approval of the Company’s request will be
17 issued by February 19, 2003.

18 **Q. Does this complete your testimony?**

19 A. Yes, it does.

SCHEDULE DJK-1

HAS BEEN DEEMED
HIGHLY CONFIDENTIAL
IN ITS ENTIRETY