

Exhibit No.:
Issues: *Insulation*
Witness: *David Murray*
Sponsoring Party: *MoPSC Staff*
Type of Exhibit: *Rebuttal Testimony*
Case No.: *GM-2003-0238*
Date Testimony Prepared: *March 17, 2003*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

DAVID MURRAY

**SOUTHERN UNION COMPANY
d/b/a MISSOURI GAS ENERGY**

CASE NO. GM-2003-0238

Jefferson City, Missouri
March 2003

BEFORE THE PUBLIC SERVICE COMMISSION

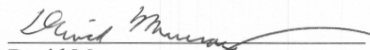
OF THE STATE OF MISSOURI

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 One Hundred Percent)
(100%) of the Equity Interests of Panhandle) Case No. GM-2003-0238
Eastern Pipeline Company, Including its)
Subsidiaries, and to Take All Other Actions)
Reasonably Necessary to Effectuate Said)
Transaction.)

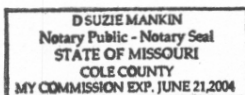
AFFIDAVIT OF DAVID MURRAY

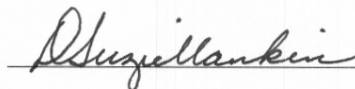
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

David Murray, being of lawful age, on his oath states: that he has participated in the preparation of the following Rebuttal Testimony in question and answer form, consisting of 20 pages to be presented in the above case; that the answers in the following Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.


David Murray

Subscribed and sworn to before me this 14th day of March 2003.





REBUTTAL TESTIMONY

OF

DAVID MURRAY

SOUTHERN UNION COMPANY

d/b/a MISSOURI GAS ENERGY

CASE NO. GM-2003-0238

Q. Please state your name.

Q. Please state your business address.

Q. What is your present occupation?

Q. Were you employed before you joined the Commission's Staff (Staff)?

Q. What is your educational background?

Q. Have you filed testimony in other cases before this Commission?

- TR-2001-344 Northeast Missouri Rural Telephone Company
- TC-2001-402 Ozark Telephone Company

Rebuttal Testimony of
David Murray

- TT-2001-328 Oregon Farmers Mutual Telephone Company
- TC-2002-1076 BPS Telephone Company
- GR-2001-292 Missouri Gas Energy
- ER-2001-672 Missouri Public Service
- ER-2002-424 The Empire District Electric Company

Q. Have you made recommendations in any other cases before this Commission?

A. Yes, I have made recommendations on finance, merger and acquisition cases before this Commission.

Q. What is the purpose of your testimony in this case?

A. My testimony addresses the financial implications of Southern Union Company's (Company, Southern Union or SUG) Application to acquire Panhandle Eastern Pipeline Company (Panhandle). The Company's Application as filed presents a detriment to Missouri Gas Energy's (MGE's) ratepayers. I will present a condition intended to eliminate the detrimental impact of Southern Union's proposal. This condition is designed to achieve insulation of the regulated utility from the business and financial risk of Southern Union's other operations and thereby, protect MGE's ratepayers.

Q. Would you define business and financial risk?

A. Yes. Business risk is the risk associated with the nature of the business and the operations of the firm. Financial risk is the risk associated with a firm's use of leverage, which is the amount of debt as it relates to total capital or some other measure. The financial risk created by the use of leverage is derived from the magnitude of this leverage and the amount of debt service associated with the leverage as it relates to cash flow.

Q. Does the Staff believe the Company's Application should be approved as filed?

Rebuttal Testimony of
David Murray

1 A. No. The application as filed has a detrimental impact on MGE's customers.
2 The application should, however, be approved with the proposed conditions outlined in
3 Chuck Hyneman's rebuttal testimony. Condition 2, which is the condition addressed in my
4 testimony, is designed to achieve insulation of MGE and thereby, remove the detrimental
5 effect of Southern Union's request.

6 Q. Why is it necessary to insulate MGE?

7 A. In the absence of insulation, the business risk and financial risk of Southern
8 Union's other operations will have an effect on MGE's regulated operations. This will
9 increase the cost of capital for the regulated utility with no offsetting benefit to the ratepayer.
10 An increase in the cost of capital is a detriment to the ratepayer. Standard & Poor's assumes
11 that an entity's creditworthiness reflects not only its own business and financial profile, but
12 also its relationships with other corporate family members, which would include Panhandle.
13 Therefore, after the proposed transaction occurs, Standard & Poor's will assign a
14 consolidated credit rating to Southern Union, which will include the operating and financial
15 characteristics of the natural gas local distribution operations, the Panhandle subsidiary and
16 Southern Union's nonregulated operations.

17 Q. What will be the effect of this consolidated rating?

18 A. Standard & Poor's, as well as other credit rating agencies, view natural gas
19 local distribution operations as being more stable than pipeline operations. For example,
20 Standard & Poor's currently assigns a business profile of 3, on a scale of 1 to 10 with 1 being
21 the least risky and 10 being the most risky, to Southern Union because its current operations
22 are predominately in the local natural gas distribution business. However, as of February 15,
23 2002, Standard & Poor's assigned Panhandle a business risk profile of 5, meaning that

Rebuttal Testimony of
David Murray

1 Standard & Poor's considers the business risk of this operation to be higher than Southern
2 Union's current operations. Consequently, the consolidated credit rating is likely to be lower
3 after this acquisition is completed, especially considering the higher initial financial leverage
4 that Southern Union will incur. Without insulation, MGE will not truly be autonomous as it
5 relates to Southern Union's other operations and consequently, will not enjoy the full benefit
6 of a lower risk profile.

7 Q. Has there been any indication by the credit rating agencies that lead you to
8 believe that Southern Union's credit ratings may be lowered as a result of its consolidation
9 with Panhandle after the acquisition?

10 A. Yes.

11 Q. Which credit rating agencies have responded to the announcement of the
12 Panhandle deal?

13 A. Standard & Poor's, Moody's and Fitch have all responded.

14 Q. What was Moody's reaction to the announcement of the proposed transaction?

15 A. Moody's confirmed the current debt rating of Southern Union Company,
16 Baa3, which is one notch above junk status, with a stable outlook after a preliminary
17 assessment of the announcement of the Panhandle deal (Schedule 1). Moody's claims that its
18 stable outlook is based upon "...the assumption that the necessary regulatory approvals
19 would be obtained in a timely manner, that SUG and AIG's Highstar Capital are able to fund
20 their respective portions of the acquisition in a timely manner and that SUG is successful in
21 its issuance of new equity to achieve its previously stated objectives of de-leveraging its
22 balance sheet."

Rebuttal Testimony of
David Murray

1 Q. How did Standard & Poor's react to Southern Union's proposed transaction of
2 Panhandle?

3 A. On December 23, 2002, Standard & Poor's placed Southern Union's credit
4 rating, BBB+, which is three notches above junk status, on CreditWatch with negative
5 implications. Standard & Poor's indicated that it would perform a more detailed review of
6 the proposed transaction in January 2003.

7 Q. What is the implication of a credit rating being placed on CreditWatch with
8 negative implications by Standard & Poor's?

9 A. A negative CreditWatch designation indicates that the credit rating may be
10 lowered.

11 Q. What type of events would cause Standard & Poor's to place a credit rating on
12 CreditWatch?

13 A. Any time an event or deviation from an expected trend has occurred or is
14 expected and additional information is necessary to take a rating action. Examples of such
15 events are: mergers, recapitalizations, regulatory actions, or unanticipated operating
16 developments.

17 Q. Has Standard & Poor's since announced its opinion after a more detailed
18 review?

19 A. Yes. On March 7, 2003, Standard & Poor's lowered Southern Union's
20 corporate credit rating to BBB, which is two notches above junk status (Schedule 2).
21 Standard & Poor's indicated that the corporate credit rating of Southern Union will be
22 assigned to the senior unsecured debt at Panhandle, indicating that Standard & Poor's
23 considers the credit risk of Southern Union and Panhandle to be the same because Southern

Rebuttal Testimony of
David Murray

1 Union now supports the Panhandle investment. In the Rationale portion of Standard &
2 Poor's Summary of Southern Union Company, Standard & Poor's states:

3 Panhandle is a major acquisition for Southern Union, and adds a lot of
4 debt to the balance sheet but the acquisition is accretive to earnings
5 and cash flow and positions the company for further debt reduction.
6 Management's plan for reducing debt seems reasonable, and
7 management's intent to shore up the balance sheet is supported by the
8 cash remaining in the company and not being paid out in dividends.
9 Standard & Poor's expects to see significant debt reduction over the
10 next two years.

11 In the Outlook Portion of the Summary, Standard & Poor's states:

12 The stable rating outlook for Southern Union is based on Standard &
13 Poor's understanding that management will be taking the necessary
14 steps to reduce debt and bring the capital structure in line with the
15 target of 50% to 55% of debt. The interest coverage targets are around
16 2.5x for EBIT interest coverage and around 3.0x for funds from
17 operations interest coverage. If the steps taken to achieve these targets
18 are inadequate, the corporate credit rating will be lowered.

19 As can be determined from the above comments, Standard & Poor's does not
20 necessarily view this as a speculative investment that will have a dire impact on Southern
21 Union's credit quality. However, they do recognize that there are some risks involved with
22 the acquisition, such as increased leverage and the ability of Southern Union to execute on its
23 intentions to reduce debt leverage. If this debt leverage is not reduced and/or Southern Union
24 encounters some type of financial difficulty because of certain business risks, then it appears
25 that Southern Union's credit rating will be downgraded.

26 The credit rating agencies must rely on commitments made by Southern Union in
27 evaluating the credit quality of Southern Union's debt. It appears that Standard & Poor's had
28 been holding off on downgrading Southern Union because Southern Union had indicated that
29 they were on course to reduce debt. However, because Southern Union announced its

Rebuttal Testimony of
David Murray

1 intention to acquire Panhandle, this debt reduction plan has changed at least for the time
2 being. Consequently, Standard & Poor's recently lowered Southern Union's credit rating.

3 Q. How has Fitch reacted to the announcement of the proposed transaction?

4 A. On December 24, 2002, Fitch placed Southern Union's credit rating, BBB,
5 which is two notches above junk status, on Rating Watch Negative. Fitch stated in a press
6 release on *CBS Marketwatch* that the Rating Watch Negative status for Southern Union
7 reflects:

8 ...the potential for higher initial leverage to complete the acquisition
9 and the structural subordination of the cash flow SUG will derive from
10 PEPL upstream dividends. As a result of initial borrowings and the
11 assumption of existing PEPL debt, SUG's consolidated debt leverage
12 and credit measures are likely to moderately weaken in the near-term.
13 Although expected cash dividends from the PEPL assets will largely
14 offset reduced earnings and cash flow at the SUG corporate level
15 resulting from the divestiture of the Texas gas utility division, Fitch
16 notes that such dividends will be subordinated to PEPL's \$1.16 billion
17 of direct debt obligations. Moreover, PEPL's existing credit
18 agreements include various dividend restriction covenants that would
19 limit SUG's ability to receive upstream cash distributions in a
20 downside scenario.

21 As can be derived from the above comments by Fitch, Southern Union will have to
22 incur higher initial borrowings to complete the deal in addition to the Panhandle debt that
23 will be consolidated on Southern Union's books. However, Southern Union will be limited
24 in the amount of cash that it can receive from Panhandle in the form of dividends.
25 Therefore, although Southern Union will be burdened with more debt on its books, it will not
26 receive the full benefit of unlimited upstream cash flow from Panhandle.

27 Q. Did Fitch provide any comments on the credit rating of Panhandle?

28 A. Yes. Fitch has given a Rating Watch Positive status to Panhandle which
29 reflects the higher rating of Southern Union as compared to that of the current owner CMS
30 Energy. This is important to note because it is obvious that Fitch is recognizing that a

Rebuttal Testimony of
David Murray

1 stronger parent company enhances the creditworthiness of the subsidiary, Panhandle in this
2 case. Essentially, if a parent company is committed to an investment, it will support the debt
3 service on the debt incurred for that investment, even if the debt is held at the subsidiary level
4 and is nonrecourse.

5 Q. If Fitch were to downgrade Southern Union after its review, would Southern
6 Union still be rated investment grade by Fitch?

7 A. Fitch indicated in its report that it does not anticipate lowering Southern
8 Union's credit rating to below investment grade. Regardless, it is important to note that
9 Moody's currently rates Southern Union's debt at only one notch above junk status and
10 Standard & Poor's currently rates Southern Union's debt at two notches above junk status. If
11 Fitch downgrades Southern Union, then Fitch would have Southern Union rated at only one
12 notch above junk status. These ratings do not allow Southern Union much of a cushion to
13 remain at investment grade if they should encounter any financial difficulties in the future.

14 Q. Has Southern Union indicated that it is committed to maintaining an
15 investment-grade credit rating?

16 A. Yes. During the Informal Interview, Mr. Karam indicated that Southern
17 Union is "...absolutely committed to maintaining our investment-grade credit rating at all
18 three agencies" (p. 185, ll. 6-8).

19 Q. Is there any reason to be concerned that Southern Union's credit rating will
20 not remain investment grade at any of the three agencies and Southern Union's commitment
21 to maintain its investment grade credit rating at all three agencies?

Rebuttal Testimony of
David Murray

1 A. Yes. First, going into this deal Southern Union contemplated three possible
2 scenarios that may occur with Moody's credit rating on Southern Union's debt. As
3 Mr. Karam indicated during the Informal Interview (p. 183, ll. 13-21),

4 Our investment bankers were telling us that Moody's -- that Moody's
5 would very likely -- I guess there's three ways they would rate you;
6 they would either immediately come out and downgrade you, they
7 would put you on negative watch or they would affirm your rating.
8 And we expected one of the two former ones. We did not expect the
9 latter, because -- just because they've been so tough lately.

10 Obviously, Southern Union was aware of the possibility that this transaction may
11 cause its credit rating at Moody's to be downgraded to below investment grade and actually
12 thought that the probability of a downgrade or a negative watch was more likely than an
13 affirmation of their current credit rating.

14 Q. Are there other issues that cause you concern about the ability of Southern
15 Union to maintain its investment grade credit rating?

16 A. Yes. Southern Union is a company that is aggressively growing through
17 acquisitions, and has financed many of these deals, at least initially, with a significant
18 amount of debt. As recently as the last rate case, Case No. GR-2001-292, Southern Union
19 only had a common equity to total capital ratio of 31.24 percent. With Moody's credit rating
20 only one notch above junk status, Standard & Poor's at two notches above junk and the
21 possibility that Fitch may lower Southern Union's credit rating to a level at only one notch
22 above junk status, the ability of Southern Union to encounter uncertain business and/or
23 financial situations without being downgraded to junk status would be much more tenuous.

24 Q. Is it possible that a negative event could occur within the Panhandle
25 operations that may have an impact on Southern Union's credit rating?

26 A. Yes. As Mr. Karam stated in the Informal Interview (p. 188, ll. 18-21),

Rebuttal Testimony of
David Murray

1 ...we can't guarantee anything in the future. The transactions and
2 efforts that we undertake are always to improve the company, but we
3 can't guarantee future action on anything.

4 Q. Are there any execution risks involved with this transaction that are of
5 concern to the credit rating agencies?

6 A. Yes.

7 Q. What are the execution risks?

8 A. Mr. Karam indicated in the Informal Interview that Southern Union believes
9 the main execution risks are the selling of certain assets, issuing equity in the near future and
10 timely regulatory approval (Informal Interview, p. 177, ll. 12-18).

11 Q. During the Informal Interview, did Mr. Karam indicate that the participation
12 of AIG Highstar was an execution risk?

13 A. No. He indicated that the credit rating agencies were not concerned about this
14 execution risk (Informal Interview, p. 178, ll. 9-12).

15 Q. In Mr. Kvapil's Direct Testimony, is there any indication that AIG's
16 investment in Panhandle is less than certain?

17 A. Yes. On page 12, lines 14 through 21, Mr. Kvapil discusses the possibility of
18 AIG not performing their portion of the acquisition. Specifically, he states:

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

1 Q. Is it possible that a company that owns utilities in Missouri may make a
2 commitment to maintain an investment grade credit rating and not be able to maintain such a
3 credit rating?

4 A. Yes. Aquila, Inc. (Aquila) is an example of a company that has agreed and
5 been ordered by this Commission to exercise reasonable diligence and prudence to maintain
6 its investment grade credit rating. This occurred as recently as the Avon/Midlands
7 acquisition case (Case No. EO-2002-215).

8 Q. Has Aquila been able to maintain its investment grade credit rating?

9 A. No. Standard & Poor's currently rates Aquila's debt B+ and is on
10 CreditWatch with negative implications. Moody's currently rates Aquila's debt B1. Fitch
11 recently downgraded Aquila's debt to B+ and is on Rating Watch Negative. All of these
12 credit ratings are below investment grade and are considered to be highly speculative.

13 Q. What appears to be the main cause for the deterioration in Aquila's credit
14 ratings?

15 A. Aquila's difficulties stemmed from its investments in the energy merchant
16 sector, which included energy marketing and trading, and wholesale generation. These
17 investments were not subject to the jurisdiction of the Missouri Public Service Commission.
18 These investments were made through the then wholly-owned, nonregulated Aquila
19 subsidiary.

20 Q. If Aquila's Missouri electric utility distribution operations, Missouri Public
21 Service and St. Joseph Light & Power, had been insulated, is it possible that they would not
22 be in danger of being filed into bankruptcy along with the parent company, Aquila?

Rebuttal Testimony of
David Murray

1 A. Yes. An example of this is in the case of Enron. Enron owned a regulated
2 electric distribution company in Oregon, Portland General Electric. Because this operation
3 was insulated from the parent company, it was not filed into bankruptcy with the parent.

4 Q. If Missouri utilities were insulated from their parent companies activities, then
5 wouldn't the actions of the Commission have a more direct impact on the financial soundness
6 of the Missouri operations?

7 A. Yes. If Missouri utilities were more autonomous financially, structurally and
8 legally, then actions of this Commission would have a more direct impact on the financial
9 viability of the Missouri operations.

10 Q. What is Southern Union's current corporate strategy on the organization of its
11 operations?

12 A. During the Informal Interview, Mr. Karam indicated that the current strategy
13 of Southern Union was to:

14 ...decentralize all of these corporate functions or what we think now
15 are corporate functions. Let's decentralize those to the operating
16 divisions and only keep at corporate those functions which are system
17 supported, which might otherwise be redundant. (Informal Interview,
18 p. 10, ll. 22-25)

19 Mr. Karam goes on further to state:

20 We operate turnkey businesses, and we provide the opportunity and
21 the responsibility for each of the presidents of our divisions to be
22 predominately autonomous in running their businesses. (Informal
23 Interview, p. 11, ll. 11-14).

24 Although it appears that Southern Union's current organizational strategy is geared
25 toward the decentralization of management functions, the financial insulation of the regulated
26 utilities would appear to go one step further towards autonomy.

Rebuttal Testimony of
David Murray

1 Q. Would Southern Union have to request approval from the Missouri Public
2 Service Commission for any future investments it may make through its subsidiary, Southern
3 Union Panhandle Corporation?

4 A. No. It appears that any further investments made by Southern Union
5 Panhandle Corporation would not be subject to review by the Missouri Public Service
6 Commission. For that matter, it does not appear that Southern Union would have to obtain
7 approval from the Commission to make an investment outside of the utility sector even if it
8 were a direct investment by the parent company, Southern Union, which also includes MGE
9 as a division.

10 Q. Have Mr. Kvapil and Mr. Karam adequately addressed the concerns outlined
11 above in their direct testimony in this case?

12 A. No. Mr. Karam claims that Southern Union's acceptance of eight specific
13 conditions that were filed with its application will insulate MGE customers from any possible
14 adverse consequences associated with this transaction. However, these conditions have
15 nothing to do with the structural and legal separation that may be required in order to
16 financially insulate MGE from the rest of Southern Union's operations.

17 Q. Why don't the conditions that Southern Union has accepted insulate MGE
18 from Southern Union and the rest of its activities?

19 A. None of the conditions accepted by Southern Union indicate that MGE's cost
20 of capital will not be affected by Southern Union's other business ventures. Southern Union
21 does make a general representation that they will not seek an increase in the cost of capital
22 for MGE's rates as a result of any increased cost of capital that Southern Union may incur as
23 a result of this transaction. However, this commitment does not ensure that capital needed

Rebuttal Testimony of
David Murray

1 for MGE investments will not have an increased cost associated with it. It merely indicates
2 that Southern Union will make a commitment to not attempt to pass these increased costs on
3 to MGE ratepayers.

4 Q. Do you have concerns as to whether Southern Union will abide by this
5 commitment?

6 A. Yes. I wrote testimony in the last MGE rate case, Case No. GR-2001-292. In
7 that case there was a disagreement as to whether the cost of capital being requested for MGE
8 was higher as a result of Southern Union's recent acquisitions of the New England and
9 Pennsylvania properties. MGE proposed a hypothetical capital structure, but still assigned
10 Southern Union debt costs to that capital structure. Southern Union's debt costs are a
11 function of all of the operations of Southern Union and Southern Union's financial leverage.
12 Southern Union's capital structure became much more heavily weighted in debt after the
13 acquisition of these properties. However, Mr. John C. Dunn, Rate of Return witness for
14 MGE in that case, did not attempt to show an adjustment to the cost of debt that he was
15 assigning to MGE, nor did he provide proof that the cost of debt that was assigned to MGE
16 was not a result of possible increased costs that Southern Union may have incurred because
17 of those previous transactions. Because of Southern Union's current corporate structure,
18 MGE has to rely on Southern Union for its debt capital. Therefore, any effects on Southern
19 Union's debt costs will impact MGE's assigned debt costs.

20 Q. Did Mr. Dunn make any other claims in the last rate case that causes you
21 concern as to whether Southern Union will comply with the condition of not requesting an
22 increase in the cost of capital for MGE as a result of a change in MGE's risk profile as a
23 consequence of the previous transactions?

Rebuttal Testimony of
David Murray

1 A. Yes. Mr. Dunn suggested in his rebuttal testimony that I should make an
2 adjustment to my recommended cost of common equity because Southern Union, and as a
3 result MGE, was more financially leveraged than the proxy companies that I used to estimate
4 the cost of common equity for MGE. This appeared to be another attempt to pass on an
5 additional cost to MGE ratepayers as a result of increased financial leverage incurred for
6 Southern Union's acquisitions.

7 Q. Notwithstanding your concerns about Southern Union's compliance with the
8 condition that was imposed on them in previous cases and is being proposed in this case, if
9 Southern Union did comply, would this satisfy your concerns about insulation of MGE from
10 Southern Union's other activities?

11 A. No. That condition only deals with a commitment to not pass through to
12 MGE ratepayers additional capital costs that Southern Union may incur as a result of this
13 transaction. It does not address financial insulation through structural and legal mechanisms
14 recognized by Standard & Poor's.

15 Q. What would be the detriment to MGE ratepayers if MGE were not insulated
16 from the rest of Southern Union's operations in the event that Southern Union should
17 encounter financial problems?

18 A. Because MGE relies on Southern Union for any capital it may need in excess
19 of internally generated funds, any financial difficulties encountered by Southern Union will
20 at the very least result in a higher cost of capital for MGE, if not a difficulty in attracting any
21 capital at all to maintain MGE's system.

1 Q. Did Southern Union indicate in the Informal Interview that they thought that
2 MGE would not be affected if Southern Union encountered financial difficulties in the future
3 as a result of its other investments?

4 A. Yes, they represented that, but they have not proven how this would be the
5 case. Mr. Karam indicated that because the debt is outstanding and it had fixed rates that if
6 Southern Union should have to file for bankruptcy, then he didn't think MGE would be
7 affected (Informal Interview, p. 199, ll. 17-25). However, he indicated that if MGE were to
8 require outside capital for investments needed in its system, debtor-in-possession financing
9 could be used to provide the necessary capital needed for MGE (p. 200, ll. 5-18).

10 Q. Would you claim that the uncertainty of what may occur to MGE's service in
11 the event Southern Union files for bankruptcy or encounters financial difficulties would be a
12 detriment to the public?

13 A. Yes. Any time a company is financially impaired there is a concern that this
14 will affect the ability of the company to provide safe and reliable service. Actually, this very
15 concern was stated in a recent FERC Order issued on February 21, 2003 on Westar Energy,
16 Inc.'s request to issue long-term, unsecured debt, Docket No. ES02-51-000. Item 22 on
17 page 7 of the order indicates the following:

18 These restrictions should prevent public utilities from borrowing
19 substantial amounts of monies and using the proceeds to finance non-
20 utility businesses. These restrictions thus should ensure that future
21 issuances of debt are compatible with the public interest, will not
22 impair a public utility's ability to perform in the future and provide
23 appropriate ratepayer protection.

24 Although it is comforting to know that FERC is attempting to ensure that funds are
25 used for their intended purpose, this does not eliminate Staff's concern about the effect that

1 Southern Union's other activities may have on MGE. The FERC order does not protect
2 utilities from the financial difficulties that may be encountered by the parent company.

3 Q. What should this Commission do in order to protect MGE from some of the
4 possible situations that you described above?

5 A. It should order Southern Union to take the necessary steps to insulate MGE.
6 The confirmation that Southern Union has taken the necessary steps to adequately insulate
7 MGE from the rest of Southern Union's operations will come from acknowledgement by the
8 credit rating agencies that such steps are adequate to safeguard MGE's financial health from
9 any possible negative consequences of Southern Union's other investments. This shall
10 include, but not be limited to, an acknowledgement that it would not be likely that MGE
11 would be filed into bankruptcy in the event that Southern Union had to file for bankruptcy.
12 The acknowledgement should also indicate that MGE, or as an alternative, the regulated local
13 gas distribution operations, would have a separate and distinct credit rating that is not based
14 on the consolidated credit profile of Southern Union's other operations outside of regulated
15 local gas distribution, which includes Panhandle as well as other nonregulated businesses.

16 This type of acknowledgment would be much like the acknowledgement that
17 Standard & Poor's gave to PPL Corp. on its restructuring announcement (Schedule 3). In
18 that case, PPL Corp. made an announcement that it was restructuring in order to insulate
19 PPLEU, its regulated electric distribution utility subsidiary, from the rest of PPL Corp.'s
20 operations. It appears that this insulation continues to be successful because Standard &
21 Poor's currently rates PPLEU two notches higher (A- with a Stable Outlook) than its parent,
22 PPL Corp. (BBB with a Negative Outlook). The fact that PPLEU enjoys a higher credit
23 rating than its parent even when the parent is still rated investment grade lends support that

Rebuttal Testimony of
David Murray

1 there is a benefit to a regulated utility being insulated even when the parent is in relatively
2 good financial health. Not only does PPLEU currently enjoy the benefit of having a better
3 credit rating than its parent company, but Standard & Poor's has also determined it to be a
4 bankruptcy remote entity. This means that there have been disincentives set up that make the
5 filing of PPLEU into bankruptcy by its parent company, PPL Corp., to be highly unlikely.

6 Q. Can you provide a little more information about the meaning of insulation and
7 its benefits?

8 A. Yes. Standard & Poor's has written many articles on the concept of
9 insulation. In a November 1998 Standard & Poor's article in *Global Sector Review*, "Utility
10 Ratings Criteria For The Changing Times," by John Bilardello, Standard & Poor's
11 commented on its ratings methodology as it relates to insulation and linkage between the
12 parent company and its subsidiaries. In this article Standard & Poor's indicates:

13 Economic incentive is the most important factor on which to base
14 judgments about the degree of linkage that exists between a parent and
15 subsidiary. This matters more than covenants, support agreements,
16 management assertions, or legal opinions. Business managers have a
17 primary obligation to serve the interest of their shareholders, and it
18 should generally be assumed that they will act to satisfy this
19 responsibility. If this means infusing cash into a unit they have
20 previously termed a "stand-alone" subsidiary, or finding a way around
21 covenants to get cash out of a "protected" subsidiary, management can
22 be expected to follow these courses of action to the extent possible. It
23 is important to think ahead to various stress scenarios and consider
24 how management would likely act under those circumstances. If a
25 parent "supports" a subsidiary only as long as the subsidiary does not
26 need it, such support is meaningless. (p. 7)

27 The article goes on to state:

28 If, in fact, there are important insulating factors and a utility would
29 merit a higher credit rating if it were stand-alone, the utility senior debt
30 and its corporate credit rating would usually be rated one notch higher
31 than the corporate credit rating, but could be even higher in the rare
32 instances when the insulation is exceptionally strong. If the insulating
33 factors are not significant enough or if the utility would not merit a

higher rating if it were stand-alone, the utility's senior debt rating and its corporate credit rating would be the consolidated corporate credit quality. (p. 9)

Q. What are some of the insulating factors that Standard & Poor's recognizes in this research article?

A. The research article goes on to list the following insulating factors:

- Regulation;
- Strategic importance—linked lines of business or critical supplier;
- Percentage ownership (current and prospective);
- Management control;
- Shared name;
- Legal system;
- Domiciled in the same country;
- Common sources of capital—equity or debt;
- Financial capacity for providing support;
- Size of the investment;
- Investment relative to the amount of debt at the venture or project;
- Financial obligations other than debt payments;
- Nature of other owners (strategic versus financial, financial capacity);
- Management's stated posture;
- Track record of parent firm in similar circumstances; and
- The nature of potential risks.

The article also lists several insulating factors in respect to regulation:

- Penalties related to credit rating downgrades;

Rebuttal Testimony of
David Murray

- Establishment of a minimum credit rating;
- Approvals to issue debt or preferred stock;
- Restrictions on dividends, advances, and loans to the parent or affiliates, or other intercompany transactions;
- Limits on approvals of nonutility investments at the utility or by the parent;
- Interest coverage tests; and
- Debt ratio tests.

Q. What should the Commission order Southern Union to do?

A. It should order Southern Union to do the following:

Southern Union shall take the necessary steps to insulate MGE. The confirmation that Southern Union has taken the necessary steps to adequately insulate MGE from Southern Union's operations other than regulated local gas distribution shall come from acknowledgement by the credit rating agencies that such steps are adequate to safeguard MGE's financial health from any possible negative consequences of Southern Union's other investments. This shall include, but not be limited to, an acknowledgement that it would not be likely that MGE would be filed into bankruptcy in the event that Southern Union had to file for bankruptcy. The acknowledgement should also indicate that MGE, or as an alternative, the regulated local gas distribution operations, would have a separate and distinct credit rating that is not based on the consolidated credit profile of Southern Union's operations outside of local gas distribution, which includes Panhandle as well as other nonregulated businesses. This plan shall be submitted to the Commission by June 30, 2003. If the Commission determines that this plan is inadequate and/or inefficient (not cost effective), then Southern Union shall submit a revised plan by the end of the next quarter. If needed, Southern Union shall continue to submit revised plans on a quarterly basis until the Commission determines that MGE has been insulated from Southern Union's operations other than local gas distribution or that the requirement is no longer needed.

Q. Does this conclude your rebuttal testimony?

A. Yes it does.

DR supplement
2/5/03
TKS

<MENU> to return to headlines.

111n Equity CN

Search

Options

Related Info

BMP Dec 23 2002 15:25

MOODY'S CNFS RTGS OF SOUTHERN UNION COMPANY WITH STABLE OUTLOOK;

Page 1/7

New York
Edward H. Tan
Vice President - Senior
Analyst
Corporate Finance Group
Moody's Investors Service
JOURNALISTS: 212-553-0376
SUBSCRIBERS: 212-553-1653

New York
John Diaz
Managing Director
Corporate Finance Group
Moody's Investors Service
JOURNALISTS: 212-553-0376
SUBSCRIBERS: 212-553-1653

MOODY'S CONFIRMS THE DEBT RATINGS OF SOUTHERN UNION COMPANY (Baa3 SR, UNS. IMPLIED) WITH STABLE OUTLOOK; DEBT RATINGS OF PANHANDLE EASTERN (Ba2 SR, UNS.) PLACED ON REVIEW WITH DIRECTION UNCERTAIN.

Approximately \$1.865 Billion of Debt Securities Affected

New York, December 23, 2002 -- Moody's Investors Service confirmed the

Australia 61 2 9777 8600

Brazil 5511 3048 4500

Europe 44 20 7330 7500

Germany 49 69 920410

Hong Kong 852 2977 6000 Japan 81 3 3201 8900

Singapore 65 212 1000 U.S. 1 212 318 2000

Copyright 2002 Bloomberg L.P.
6819-862-0 24-Dec-02 7:48:36

Bloomberg
PROFESSIONAL

<MENU> to return to headlines.

111n Equity CN

Search **MOODY'S CNFS RTGS OF SOUTHERN UNION COMPANY WITH STABLE OUTLOOK;** Options Related Info BMP Dec 23 2002 15:25

Page 2/7

MOODY'S CNFS RTGS OF SOUTHERN UNION COMPANY WITH STABLE OUTLOOK; ratings (Baa3 senior unsecured debt and senior implied debt ratings) of Southern Union Company ("SUG"), following its preliminary assessment of the company's announcement to purchase Panhandle Eastern Pipeline Company ("Panhandle") from CMS Energy Corporation, together with the American International Group, Inc.'s ("AIG") Highstar Capital, L.P. private equity-fund.

SUG's 75% portion of the \$660MM cash consideration will be primarily funded by the \$420MM cash proceeds resulting from its October 2002 agreement to sell its Texas LDC properties to ONEOK, Inc. While the acquisition is subject to execution risk as it is subject to Federal Trade Commission (under the Hart-Scott-Rodino Act) and certain state regulatory approvals, SUG has indicated that it intends to move forward with a sizeable equity offering in the near term to further strengthen its balance sheet, in light of the \$1.2 BN in debt that it, along with the AIG's Highstar Capital, would be incurring in the acquisition of Panhandle. Moreover, SUG had plans to de-leverage its own balance sheet even before the Panhandle acquisition was contemplated and has indicated that it would consider various means of monetizing other non-essential assets of Panhandle as well, in order to further reduce debt of the combined entity. Moody's is basing its stable outlook on SUG on the

Australia 61 2 9777 8600

Brazil 5511 3048 4500

Europe 44 20 7330 7500

Germany 49 69 920410

Hong Kong 852 2977 6000 Japan 81 3 3201 8900

Singapore 65 212 1000 U.S. 1 212 318 2000

Copyright 2002 Bloomberg L.P.
6819-862-0 24-Dec-02 7:48:39

Bloomberg
PROFESSIONAL

<MENU> to return to headlines.

111n Equity CN

Search Options Related Info BMP Dec 23 2002 15:25

MOODY'S CNFS RTGS OF SOUTHERN UNION COMPANY WITH STABLE OUTLOOK; Page 3/7
assumption that the necessary regulatory approvals would be obtained in a timely manner, that SUG and AIG's Highstar Capital are able to fund their respective portions of the acquisition in a timely manner and that SUG is successful in its issuance of new equity to achieve its previously stated objectives of de-leveraging its balance sheet. During the next several weeks, Moody's intends to closely monitor these developments.

As part of its overall due diligence, SUG confirms that it has made an appropriate assessment of the environmental liabilities of Panhandle and determined that no environmental liabilities exist that could have a material impact upon its financial results or operations.

Moody's rating on Panhandle (Ba2 Sr. Uns.) are placed on review with Direction Uncertain. They were previously on review for downgrade. The review will focus on the probability of the transaction being consummated and the relative placement of Panhandle's securities in the combined corporate structure.

Panhandle is a natural gas transmission company that is expected to continue generating relatively stable cash flows, sufficient to cover its capital expenditure requirements. Any excess cash flow could be loaned

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 920410
Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 212 1000 U.S. 1 212 318 2000 Copyright 2002 Bloomberg L.P.
6819-862-0 24-Dec-02 7:48:41



<MENU> to return to headlines.

111n Equity CN

Search Options Related Info BMP Dec 23 2002 15:25

MOODY'S CNFS RTGS OF SOUTHERN UNION COMPANY WITH STABLE OUTLOOK; Page 4/7
or distributed to its shareholders in the form of dividends. Earnings
generated by Panhandle should be accretive to earnings of its
shareholders in the first year and SUG also expects to derive operational
savings through the integration of certain administrative and shared
services with its existing LDC business.

Moody's rating on CMS Energy Corporation (B3 Sr. Uns., under review for
possible downgrade) will remain unchanged at the present time.

Confirmed Ratings for SUG are:

Southern Union Company -- Baa2 senior secured debt; Baa3 senior unsecured
debt; Baa3 senior implied ratings.

Southern Union Financing I -- Ba1 BACKED preferred securities.

Headquartered in Wilkes-Barre, Pennsylvania, Southern Union Company
currently markets and distributes natural gas to nearly 1.5 million
customers primarily located in Texas, Missouri, Pennsylvania, Rhodes
Island and Massachusetts.

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 920410
Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 212 1000 U.S. 1 212 318 2000 Copyright 2002 Bloomberg L.P.
6819-862-0 24-Dec-02 7:48:46

Bloomberg
PROFESSIONAL

STANDARD & POOR'S	RATINGS DIRECT
----------------------	----------------

Research:

Return to Regular Format

Summary: Southern Union Co.

Publication date: 07-Mar-2003

Credit Analyst: Judith Waite, New York (1) 212-438-7677

Credit Rating: BBB/Stable/--

■ Rationale

On March 7, 2003, Standard & Poor's Ratings Services lowered the corporate credit rating on gas utility Southern Union Co. to 'BBB' from 'BBB+', and removed the rating from CreditWatch where it was placed on Dec. 23, 2002, when the company announced that it would purchase CMS Panhandle Pipeline Cos. (BB/Watch Pos/--). The purchase price is \$1.83 billion, including \$1.2 billion of debt. The outlook is now stable.

Pennsylvania-based Southern Union has debt totaling \$1.3 billion.

Southern Union, through a new subsidiary, Southern Union Panhandle, will acquire three gas pipelines, including Panhandle Eastern Pipeline, Trunkline Gas Co. and Sea Robin Pipeline, along with the Trunkline LNG facility. It is expected that AIG Highstar Capital L.P. will become a minority owner through an investment of non-voting preferred stock.

The corporate credit rating is assigned to the senior unsecured debt at Southern Union and will be assigned to the senior unsecured debt at Panhandle, when the transaction closes. Standard & Poor's does not view the senior unsecured debt as being disadvantaged by the \$115 million of secured debt at the Pennsylvania and New England utilities, so the unsecured debt rating is not rated a notch below the corporate credit rating. When the debt of the Pennsylvania and New England utilities was assumed by Southern Union, the mortgage indenture was closed. Conversely, because the collateral backing the first mortgage bonds is more than twice the value of the debt, that rating is 'A-', two notches above the corporate credit rating. Southern Union's preferred stock is rated 'BB+'.

Panhandle is a major acquisition for Southern Union, and adds a lot of debt to the balance sheet but the acquisition is accretive to earnings and cash flow and positions the company for further debt reduction. Management's plan for reducing debt seems reasonable, and management's intent to shore up the balance sheet is supported by the cash remaining in the company and not being paid out in dividends. Standard & Poor's expects to see significant debt reduction over the next two years.

Liquidity.

Southern Union has modest liquidity requirements, which are adequately covered by cash from operations and bank facilities. The \$150 million revolving credit matures June 9, 2003, and the \$225 million revolving credit matures May 29, 2004. Only Panhandle has debt maturing over the next two years of \$292 million in March and \$100 million in August 2004. Southern Union has good access to the capital markets, and has shelf registrations filed with the SEC for \$1.2 billion for both debt and equity. Available cash flow, which exceeds capital expenditures by 45% in the years 2003 to 2005, will be used to reduce debt. The company does not pay a dividend on common stock.

■ Outlook

The stable rating outlook for Southern Union is based on Standard & Poor's understanding that management will be taking the necessary steps to reduce debt and bring the capital structure in line with the target of 50% to 55% of debt. The interest coverage targets are around 2.5x for EBIT interest coverage and around 3.0x for funds from operations interest coverage. If the steps taken to achieve

Schedule 2-1

these targets are inadequate, the corporate credit rating will be lowered.

Ratings list:

RATINGS LOWERED, OFF WATCH

TO FROM

Southern Union Co.

Corporate credit rating BBB/Stable/-- BBB+/Watch Neg/--

Preferred stock BB+ BBB-/Watch Neg

Senior secured debt A- A/Watch Neg

Senior unsecured debt BBB BBB+/Watch Neg

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; under Fixed Income in the left navigation bar, select Credit Ratings Actions.

Copyright © 1994-2003 Standard & Poor's, a division of The McGraw-Hill Companies.
All Rights Reserved. Privacy Policy

The McGraw-Hill Companies

STANDARD & POOR'S	RATINGS DIRECT
----------------------	----------------

Return to Regular Format

Research:

S&PCORRECT: PPL Corp.'s, Unit's Ratings Affirmed After Restructuring Announcement

Publication date: 17-May-2001

Credit Analyst: Todd A Shipman, CFA, New York (1) 212-438-7676

(Editor's note: In the press release issued earlier today, reference to debt that PPL Corp. guarantees was omitted. A corrected version follows.)

NEW YORK (Standard & Poor's CreditWire) May 17, 2001--Standard & Poor's today affirmed its corporate credit (BBB+/A-2) and commercial paper ratings on PPL Corp. In addition, Standard & Poor's affirmed its ratings on PPL Electric Utilities Corp. (PPLEU; A-/A-2). The rating actions followed PPL Corp.'s announcement that it will strategically restructure PPLEU. (A complete list of ratings is available on RatingsDirect, Standard & Poor's on-line credit research service, or by calling the Standard & Poor's ratings desk at (1) 212-438-4800). In addition, Standard & Poor's raised its rating on PPL Capital Funding Inc.'s and PPLEU's senior unsecured issues (which are guaranteed by PPL Corp.) to triple-'B'-plus from triple-'B'.

The outlook is stable.

In the proposed transaction, PPLEU will be legally insulated from the rest of PPL Corp. by changing into a single-purpose entity. Other structural components will be a part of the separation that is designed to strengthen PPLEU's business and financial risk profile (e.g. ratings maintenance tests and dividend restrictions). In addition, PPL plans to take steps to reduce PPLEU's risk in connection with its obligation to provide electricity to existing utility customers by entering into a long-term supply contract to satisfy those needs.

The restructuring is expected to result in an improvement in PPLEU's business risk, as the covenants restrict the ability of PPL Corp. to fully access the cash flows of the utility to support its other business ventures. However, the improved business profile will be counteracted with increased leverage at the utility, such that the credit quality will be maintained at the single-'A'-minus level. In the future, Standard & Poor's expects financial policy at PPLEU to be consistent with the current rating.

By separating the attractive credit profile of PPLEU from the consolidated credit strength of the rest of PPL Corp., the net effect of the restructuring on the business profile of PPL Corp. is somewhat negative. However, the transaction provides for a strengthening of PPL Corp.'s balance sheet through debt reduction and equity infusion that reduces financial risk enough to counteract the increase in business risk. Although PPL Corp.'s corporate credit rating remains unchanged, the legal insulation of PPLEU from PPL Corp. removes the need to notch the holding company's senior debt to reflect structural subordination.

OUTLOOK: STABLE

The stable outlook is based upon consistent nuclear operating performance, the supportive nature of Pennsylvania regulation, effective cost controls, a low common dividend payout, and improving financial parameters. Upside ratings potential will be restrained by risks associated with the company's fast-growing unregulated generation business, Standard & Poor's said. --CreditWire

Schedule 3-1

Copyright © 1994-2003 Standard & Poor's, a division of The McGraw-Hill Companies.
All Rights Reserved. Privacy Policy

The McGraw-Hill Companies

Schedule 3-2