LAW OFFICES
BRYDON, SWEARENGEN & ENGLAND
PROFESSIONAL CORPORATION
312 EAST CAPITOL AVENUE
P.O. BOX 456
JEFFERSON CITY, MISSOURI 65102-0456

AREA CODE 573
TELEPHONE 635-7166
FACSIMILE 634-7431

DAVID V.G. BRYDON
JAMES C. SWEARENGEN
WILLIAM R. ENGLAND III
JOHNNY K. RICHARDSON
GARY W. DUFFY
PAUL A. BOUDREAU
SONDRA B. MORGAN
SARAH J. MAXWELL
CHARLES E. SMARR
MARK G. ANDERSON
DEAN L. COOPER
TIMOTHY T. STEWART
GREGORY C. MITCHELL
RACHEL M. CRAIG
BRIAN T. McCARTNEY

August 17, 1999

FILED

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Missouri Public
Service Commission

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

Re: Case No. GM-2000-49

Dear Mr. Roberts:

Enclosed for filing with the Missouri Public Service Commission please find an original and fourteen (14) copies of the Reply of Southern Union Company to Staff Response to Application For Reconsideration or Rehearing.

Would you please bring this filing to the attention of the appropriate Commission personnel.

Thank you for your assistance in this matter.

Very truly yours,

James C. Swearengen

JCS/jlh
Enclosures

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of Southern Union Company for authority to Acquire up to and Including Five Percent (5%) of the Common Stock of Pennsylvania Enterprises, Inc.	))))	Case No. GM-2000-49

REPLY OF SOUTHERN UNION COMPANY TO STAFF RESPONSE TO APPLICATION FOR RECONSIDERATION OR REHEARING

COMES NOW Southern Union Company ("Southern Union"), by counsel, and for its Reply to the Staff Response to Application for Reconsideration or Rehearing states as follows to the Missouri Public Service Commission ("Commission").

1. Southern Union respectfully urges the Commission to remove the condition contained in paragraph ordered 8 of its order issued in the referenced matter on July 29, 1999.

The condition at issue is as follows:

> That for purposes of determining the appropriate level of equity balances, the term ownership equity shall be defined as those funds or securities, which have the most subordinate claim against the assets of Southern Union Company as compared to all other securities or claims upon the assets of Southern Union Company. Owner's equity does not include securities such as long term debt instruments, hybrid equity securities such as SUC's trust originated preferred securities, preferred stock, or short-term debt.

The condition should be removed for two principal reasons. First, it is not relevant to the subject of the application. Second, it is unlawful and unreasonable.

2. The condition is clearly irrelevant to the subject of the application which seeks authority for Southern Union to acquire up to 5% of the stock of Pennsylvania Enterprises, Inc.

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pending completion of a merger between the companies. The merger is the subject of Southern Union's separate application which has been docketed as Case No. GM-2000-43. The question of appropriate levels of "equity balances" has absolutely nothing to do with the proposed transactions. No ratemaking treatment is sought by Southern Union in either case with respect to any existing or proposed capital structure. In fact, the ultimate merger of Southern Union with Pennsylvania Enterprises, Inc. will result in an improvement of Southern Union's capital structure in that it will substantially increase Southern Union's common equity component. Simply stated, the condition makes absolutely no sense in the context of this case.

3. Also, the condition is clearly unreasonable from a factual and evidentiary standpoint. The question of the use of trust originated preferred securities as an equity component of Southern Union's capital structure was fully litigated and decided by the Commission in Case No. GR-96-285. In that proceeding, after having received extensive evidence on the issue and the matter having been fully briefed by the parties, the Commission ruled and found that the trust originated preferred securities issued by Southern Union constitute the creation of equity, not debt. A copy of pages 61-66 of Southern Union's Reply Brief in that case is Attachment A hereto for the Commission's convenience. The Commission is urged to review this portion of Southern Union's brief which concisely and persuasively explains why trust originated preferred securities are equity and not debt. The rationale discussed therein and accepted by the Commission is equally applicable today. No evidence has been presented in this proceeding and no facts exist which would permit the Commission to make a contrary finding.

4. The condition is also unlawful. Though administrative agencies are given broad discretion when deciding a case, courts have held that administrative agencies must provide a

principled explanation when departing from a prior body of precedent. *See Motor Vehicle Manufacturers Association of the U. S. v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 103 S.Ct. 2856, 77 L.Ed2d 443 (1983); National *Black Media Coalition v. FCC*, 775 F.2d 342, 355 (D.C. Cir. 1985); *New England Tel. & Tel. Co. v. Public Utility Commission*, 446 A.2d 1376 (R.I. 1982); *In Re the Application of Northwestern Bell*, 374 N.W.2d 758 (Minn. App. 1985).

The U.S. Supreme Court in *Atchison, Topeka & Santa Fe Railway Co. v. Wichita Board of Trade*, 412 U.S. 800, 806-817, 93 S.Ct. 2567, 2374-2379, 37 L.Ed.2d 350 (1973), upheld a remand to the Interstate Commerce Commission, ordering that the agency discuss the matters in its order. Specifically, the Court stated:

> Adjudicated cases may and do, of course, serve as vehicles for the formulation of agency policies, which are applied and announced therein. See H. Friendly, *The Federal Administrative Agencies*, 36-52 (1962). They may generally provide a guide to action that the agency may be expected to take in future cases. Subject to the qualified role of stare decisis in the administrative process, they may serve as precedents. *NLRB v. Wyman-Gordon Co.*, supra 394 U.S. at 765-766, 89 S.Ct. at 1429 (Opinion of Fortas, J.). This is essentially a corollary to the general rule requiring that the agency explain the policies underlying its action. A settled course of behavior embodies the agency's informed judgment that, by pursuing that course, it will carry out the policies committed to it by Congress. There is, then, at least a presumption that those policies will be carried out best if the settled rule is adhered to. From this presumption flows the agency's duty to explain its departure from prior norms. 412 U.S. at 807-808, 93 S.Ct at 2374-75.

This principle was followed in *Office of Communication of Church of Christ v. Federal Communications Commission*, 560 F.2d 529 (2nd Cir. 1977). In that case the Second Circuit Court of Appeals reversed a decision of the Federal Communications Commission which ordered ten employees to submit detailed programs for Equal Employment Opportunity compliance instead of five. The court indicated that this change was arbitrary and capricious, and held that reviewing courts must consider whether or not the agency has articulated a rational connection between the

facts found and the choice made. The court stated:

> . . .such changes in policy must be rationally and explicitly justified in order to assure 'that the standard is being changed and not ignored, and. . .that [the agency] is faithful and not indifferent to the rule of law.' Although an agency must be given flexibility to reexamine and reinterpret its previous holdings, it must clearly indicate and explain its action so as to enable completion of the task of judicial review. * * * There must be a thorough and comprehensible statement of the reasons for the decision. 560 F.2d 529 at 532.

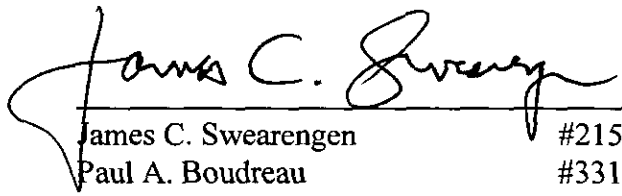
The Court of Appeals for the D.C. Circuit has also recognized this principle. In *Hatch v. Federal Energy Regulatory Commission*, 654 F.2d 825 (D.C. Cir. 1981), the court remanded the decision to the FERC because the agency had not sufficiently explained why it decided to depart with existing precedent. Even though the court concluded that the agency made the right decision, the agency was ordered to state the rational for its decision. Specifically, the court indicated:

> As a general matter, an agency is free to alter its past ruling and practices even in an adjudicatory setting. . .However, it is equally well settled that an agency must provide a reasoned explanation for any failure to adhere to its own precedents. [citations omitted] As Judge Leventhal stated in *Greater Boston* [*Television Corp. v. FCC* 444 F.2d 841, 852 (D.C. Cir. 1979), cert. den. 403 U.S. 923, 91 S.Ct. 2229, 29 L.Ed.2d 701 (1971)]: '[A]n agency changing its course must supply a reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored, and if an agency glosses over or swerves from prior precedents without discussion, it may cross the line from tolerably terse to intolerably mute.'" 654 F.2d 825 at 854.

In *National Black Media Coalition, supra.*, the Court of Appeals for the D.C. Circuit reiterated this principle when it held that in not giving an explanation as to the reason for the departure from an agency precedent, the court, in effect, ignored the precedent. 775 F.2d at 355.

In view of the foregoing cases, the Commission's departure from its precedent without a reasoned explanation based upon competent and substantial record evidence renders the condition unlawful.

Respectfully submitted,



James C. Swearengen #21510
Paul A. Boudreau #33155
BRYDON, SWEARENGEN & ENGLAND P.C.
312 E. Capitol Avenue
P. O. Box 456
Jefferson City, MO 65102-0456
(573) 635-7166

ATTORNEYS FOR SOUTHERN UNION COMPANY

Certificate of Service

I hereby certify that a true and correct copy of the above and foregoing document was sent by U.S. Mail, postage prepaid, or hand-delivered, on this 17TH day of August, 1999, to:

The Office of the Public Counsel
Truman Building, Room 250
P.O. Box 7800
Jefferson City, MO 65102-7800

James C. Swearengen

witness Featherstone, it is stated that the Staff "does not take issue with MGE's interpretation of using a monthly amortization if the Commission believes that represents a more accurate amount." The Commission, in approving the stipulation, did not cede its authority to make a just and reasonable rate base determination in a subsequent rate case. In this regard, it is readily apparent that MGE's proposal is just and reasonable in that it represents a more accurate match for ratemaking purposes than does the proposal of the Staff and OPC. The Commission is not prohibited from and should, in fact, adopt the $23 million rate base offset as urged by MGE and as updated through the October 31, 1996 true-up period.

4.1 Required Capital Structure to Implement Rates

Response to Staff, OPC and Riverside/Mid-Kansas: This issue has as its background the stipulation approved by the Commission in Case No. GM-94-40 which provided, in paragraph 2, that MGE could not implement a general increase in non-gas rates for three years from the date of the closing of the acquisition of its Missouri gas properties nor, in accordance with paragraph 7, could it implement an increase at that time unless it had attained a total debt to total capital ratio which does not exceed S&P's Benchmark ratio to be determined at the time the rate case is filed.

The Commission has obviously already given considerable thought to the capital structure required on the part of Southern Union to permit the implementation of a rate increase in this case. As has been noted, the Commission held in its October 15, 1996, order that with respect to the required capital structure to implement rates, "the dispositive issue is whether the preferred stock in the capital structure of Southern Union Company is to be considered debt or equity." The OPC, at page 4 of its initial brief, concurs.

MGE has suggested that the most appropriate and relevant classification of Southern Union's preferred stock is that given to it by Standard & Poor's Corporation ("S&P") using

S&P's definitions. This is because the parties agreed and the Commission ordered that the S&P benchmark is the standard which must be met before rates can be implemented in this case. In establishing this standard, S&P does not consider preferred stock to be debt.[13] Contrary to OPC's charge at page 8 of its initial brief, however, MGE has not argued that the Commission must accept at face value the S&P classification, although for the reasons stated by MGE in its initial brief, including the fact that the stipulation provides that S&P's definitions will be used, the S&P view is highly persuasive and may have already been tacitly agreed to by the parties. In any event, what is apparent is the fact that the other parties, to one degree or another, have lost track of the language of paragraph 7 which has given rise to this issue.

Once again, a reading of paragraph 7 of the stipulation in Case No. GM-94-40 clearly demonstrates that Southern Union agreed not to implement a general increase in non-gas rates until it has attained a total debt to total capital ratio which does not exceed S&P utility financial benchmark ratio for the lowest investment grade investor-owned natural gas distribution company measured at the time a general rate increase case is filed.

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[13] S&P is not alone in its opinion that preferred stock such as that issued by Southern Union is not debt. In interpreting its Policy on Risk-based Capital for bank holding companies, the Federal Reserve Board recently indicated its approval of these types of financing instruments as "Tier 1 Capital" if they, like Southern Union's preferred stock, have dividend deferral periods of at least five years and have the associated intercompany debt subordinated to other subordinated debt. (A copy of the Federal Reserve Board press release is attached as Appendix A to this brief). As defined in 12 CFR Part 325 Appendix A, "Tier 1" or "core" capital consists of common equity, noncumulative perpetual preferred stock, and minority interests in equity capital of consolidated subsidiaries. This "core" capital is distinguished from "Tier 2" or "supplementary" capital which must be limited to meet capital adequacy standards. "Tier 2" capital includes cumulative perpetual preferred stock, long-term preferred stock, variable dividend perpetual preferred stock, term subordinated debt, and mandatory convertible debt. In evaluating bank holding company credit risks, the Federal Reserve Board considers preferred stock, such as that issued by Southern Union, to be just that. It also considers such stock to be comparable to common equity or noncumulative perpetual preferred stock and superior to other types of preferred stock.

In accordance with the stipulation, the time of filing of the rate case is critical because the benchmark is established on that date. The present rate case was filed on March 1, 1996. On that date, the S&P benchmark total debt to total capital ratio for an investment grade gas company, calculated in accordance with S&P's method, was 58% debt.[14] (Ex. 90, p. 24; Ex. 76, p. 27; Ex.99, p. 5; Ex. 105, p. 5).

Consequently, there can be no argument that the benchmark ratio for purposes of this case is 58%. Furthermore, there can be no argument that in accordance with the stipulation, before rates may be implemented as a result of this case, Southern Union's capital structure must have a total debt to total capital ratio of 58% or less. In other words, the benchmark, established on March 1, 1996, must be met when the new rates are implemented, meaning "put into effect."[15]

Assuming the preferred stock is not reclassified as debt, the stipulated capital structure for Southern Union in this case is a total debt to total capital ratio of 54.12%. Thus, as indicated at the outset, the dispositive issue concerning the implementation of rates pertains to whether or not the preferred stock is reclassified as debt. (Ex. 2, p. 36).[16]

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[14] The Staff agrees that the intent of this condition has been met. (Staff Initial Brief, p. 111) Even if the more stringent interpretation were imposed, which would require the "average" business position of 53% debt to be considered, Southern Union would have met this test prior to implementation of new rates since its June 30, 1996 total debt to total capital ratio was 51.48% (Ex. 91, pp. 4-5)

[15] The notion that MGE cannot file a rate case until three years after the closing of its acquisition is simply wrong. Paragraphs 2 and 7 of the stipulation in Case No. GM-94-40 make it clear that the three year waiting period is for purposes of implementation, not filing. With a March 1, 1996 filing date; the operation of law or rate implementation date in this case is February 1, 1997 which is three years from January 31, 1994, the date of the closing of the transaction. This is consistent with paragraph 2 of the stipulation wherein Southern Union agreed not to implement a rate case for three years from date of closing.

[16] The special financing subsidiary created by Southern Union should not be looked at separate and apart from Southern Union. The sole purpose of the existence of the subsidiary was to issue

There is no question that preferred stocks are generally considered hybrid securities which possess features of both stocks and bonds. Indeed, Southern Union's preferred stock has most of the characteristics of typical preferred stock as indicated below.

- Callability: Most preferred stocks have call provisions which allow firms to retire the stocks through sinking funds. Similarly, Southern Union's preferred stock may be called and redeemed between 2025 and 2044 (Ex. 109, p. S-2).

- Participation in Earnings: Most preferred stocks do not share, or participate, in the firms' earnings with common stockholders. Likewise, the holders of Southern Union's preferred stock do not participate in Southern Union's earnings; rather, they only receive cumulative cash distributions at an annual rate of 9.48 percent on a $25 value per preferred security (Ex. 109, p. S-2).

- Voting Rights: Most preferred stocks have no voting privileges, except if preferred dividends have not been paid for a specified period of time. Likewise, the holders of Southern Union's preferred stock have no voting rights, except in very limited instances. (Ex. 109, p. S-15).

- Priority in Earnings: Preferred stocks are normally subordinate to debt with regard to earnings, while they usually have senior claims to income after interest and taxes relative to common stockholders. Correspondingly, Southern Union's preferred stock is subordinate and junior in right of payment to all senior indebtedness of Southern Union (Ex. 109, p. S-2), and has a preference over the holders of common stock with respect to distributions (Ex. 109, p. S-1).

- Priority in Assets: In the event of bankruptcy, the claims of preferred stockholders are normally subordinate to the claims of senior debtors, but senior to those of common stockholders. Likewise, Southern Union's preferred stock is subordinate and junior in right of payment to all senior indebtedness of Southern Union (Ex. 109, p. S-2), and has a preference over the holders of common stock with respect to redemption and liquidation (Ex. 109, p. S-1).

- Cumulative Dividends: Most preferred stock agreements require that all past unpaid preferred dividends must be paid before common stock dividends can be declared.

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the preferred stock on behalf of Southern Union and obtain the tax deductibility of the preferred dividends which, in turn, benefit MGE's customers. For this reason the investment community considers Southern Union and its subsidiary to be one and the same. (Ex. 91, pp. 5-6) Thus, the so-called "stand alone" capital structure discussed by Staff in the context of the rate implementation requirement has no meaning.

Dividends on Southern Union's preferred stock are similarly cumulative (Ex. 109, p. S-2).

- Maturity: Although nominally perpetual, most preferred stock agreements provide for systematic retirements (e.g. sinking funds), which effectively create maturity dates. Correspondingly, Southern Union's preferred stock effectively matures between 2025 and 2044, when it may be redeemed (Ex. 109, p. S-2).

Because Southern Union's preferred stock possesses the characteristics of "normal" preferred stock, there is no reason for the Commission to reclassify it as debt. Moreover, the provision calling for all interest then accrued to become due if not paid for 20 consecutive quarters (Ex. 109, Preferred Stock Prospectus Supplement, p. S-23) should not be cause for alarm.[17] The likelihood of these terms being enforced is extremely remote. This is so because of Southern Union's improving financial condition and various options available to it to meet cash requirements. For example, Southern Union's 1996 fiscal year earnings (after taxes and interest) exceeded $26 million, and its cash flow from operations was about $73 million. Dividends on Southern Union's preferred stock paid from these amounts were $9.48 million. (Ex. 172)[18] Thus, it is highly unlikely that events which could trigger the inability to pay the preferred stock dividends for five years will occur.[19]

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[17] See footnote 13. The Federal Reserve Board thinks this condition is sufficient to consider this type of instrument as non-debt.

[18] Southern Union's ability to meet its preferred stock dividend payments is reinforced by its policy of paying stock, rather than cash, dividends on its common stock. Whereas the typical local gas distribution company pays between 70 and 85 percent of its earnings out as cash dividends (Ex.10, Sched. FJC-1), Southern Union's common stock dividend policy preserved between $15 and $18 million in cash in the 1996 fiscal year.

[19] For example, if Southern Union experienced the warmest Missouri winter since 1960, it would lose about $4.8 million in revenue, and $2.9 million after tax (based on Staff witness Patterson's estimate of $6,500 per heating degree day). Weather normalization clauses now cover approximately 60% of Southern Union's Texas customers (Ex. 92, p. 6) and temperatures are not as an important determinant of revenue generation in these jurisdictions, so weather impacts there will be smaller. However, assuming $6.7 million in lost revenue company-wide

The point of all this is that there is ample evidence for the Commission to conclude, as has S&P, the Federal Reserve Board and others, that preferred stock of the variety issued by Southern Union is just that - - preferred stock, and that it should not be reclassified as debt. Through the issuance of its preferred stock with the tax deductibility feature, Southern Union has not only satisfied the S&P benchmark but it has also generated potential annual savings for its Missouri customers ranging from $2.8 to $4.4 million. (Ex. 172)

Finally, the notion raised by Riverside/Mid-Kansas that Southern Union's financial condition remains poor is inaccurate. This claim is inconsistent with the fact that Southern Union is rated as investment grade. It is also at odds with recent analyses of Southern Union prepared by Smith Barney and Merrill Lynch. The evidence is that Smith Barney lowered the risk rating of Southern Union to "medium" and its outlook for Southern Union in the industry to "Outperform". Both have indicated that Southern Union's financial condition has improved and is expected to continue to strengthen. (Ex. 10, Sched. FJC-1)

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from a year of historically warm weather in Missouri and Texas, or $4.0 after tax, the resulting impact on cash flow would not itself prevent Southern Union from paying the preferred stock dividends. Further, it is unrealistic to believe that five consecutive years of such abnormal weather would be experienced. While other events beyond Southern Union's control could adversely affect earnings or cash flow, Southern Union would always have the option to seek rate relief in its various jurisdictions to recover these impacts (Tr. 1020-1021). Rate increases would allow Southern Union to make the necessary interest and dividend payments well before the end of the five year deferral period. Finally, if cash availability is temporarily reduced, Southern Union has other options to replace it. Southern Union currently holds some $17 million in securities which could be sold while other assets, such as the Austin headquarters building, could be refinanced to raise cash. None of these actions would affect the provision of utility service. Furthermore, Southern Union has a $100 million credit line, and the largest net draw on this resource to date has been $55 million so at least $45 million would be available to fund temporary cash shortfalls. (Ex. 92, Sched. BHF-7).