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August 12, 1999

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FILED

AUG 12 1999

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: Case No. GM-2000-49 - Southern Union Company

Dear Mr. Roberts:

Enclosed for filing in the above-captioned case are an original and fourteen (14) conformed copies of a **STAFF RESPONSE TO APPLICATION FOR RECONSIDERATION OR REHEARING.**

This filing has been mailed or hand-delivered this date to all counsel of record.

Thank you for your attention to this matter.

Sincerely yours,

Cliff E. Snodgrass
Senior Counsel
(573) 751-3966
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Enclosure
cc: Counsel of Record

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

FILED

AUG 12 1999

Missouri Public
Service Commission

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

STAFF RESPONSE TO APPLICATION FOR RECONSIDERATION OR REHEARING

On August 5, 1999, the Commission directed the Staff of the Missouri Public Service Commission ("Staff") to respond to an application by Southern Union Company ("SUC") for reconsideration or rehearing, in connection with a request to remove the terms of paragraph 8 from an Order of the Commission entered on or about July 30, 1999. Specifically, the Commission directed the Staff to respond to SUC's contention that "equity balances" is not a relevant consideration in SUC's application because SUC is not seeking ratemaking treatment with respect to its existing or any proposed capital structure. The paragraph SUC seeks to have removed, reconsidered or reheard is set out below.

PARAGRAPH 8 OF THE COMMISSION ORDER

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.

**STAFF'S POSITION IS THAT THE COMMISSION CAN PROPERLY CONSIDER
EQUITY BALANCES IN ACQUISITION APPLICATIONS**

LEGISLATIVE AUTHORITY FOR STAFF'S POSITION: The legislature has specifically stated in Chapter 386, of the Missouri Revised Statutes, entitled Incorporation and Regulation of certain Utilities and Carriers, Section 610,1994, that:

"...provisions of this chapter shall be liberally construed with a view to the public welfare, efficient facilities and substantial justice between patrons and public utilities."

JUDICIAL AUTHORITY FOR THE STAFF'S POSITION: The Missouri Supreme Court has supported the legislative idea that the Commission has jurisdiction to act in the public interest. In **State ex rel. City of St. Louis v. Public Service Commission of Missouri, et al**, 73 S.W. 2d 393 (1934), the Court, discussing the Public Service Commission Act, stated, in part:

"The whole purpose of the Act is to protect the public. The public served by the utility is interested in the service rendered by the utility and the price charged therefore; investing public is interested in the value and stability of the securities issued by the utility. The Court then goes on to confirm that the Act "...shall be liberally construed with a view to the public welfare, efficient facilities and substantial justice between patrons and public utilities."

**PUBLIC INTEREST CONCERNS REASONABLY CONNECTED WITH UTILITY
ACQUISITION APPLICATIONS**

ANALYSIS: SUC contends that appropriate levels of "equity balances" is not a "relevant" consideration for consideration by the Commission since SUC is not seeking rate making treatment in this transaction. Staff believes that equity versus debt ratios are extremely relevant in acquisition transactions regardless of whether ratemaking is involved. Essentially, the Staff feels that because

there are public interest concerns connected to asset acquisitions by a regulated utility company related to reasonable levels of debt versus equity, it is proper, appropriate and relevant that the Commission address these issues to protect the public.

In common sense terminology, SUC is buying something in this case, and it is spending money to do so. This expenditure of monies may create a situation where the debt incurred to make the purchase creates an unreasonable debt to equity ratio resulting in possible financial instability.

Financial instability can become a genuine reality when a utility company becomes too highly "leveraged," or in plain language, has too much debt in relation to its ownership interests in the enterprise. The increased leverage results in a larger debt service burden, which in turn, uses up corporate earnings to satisfy these debt obligations. Taken to an unreasonable level, too much leverage can result in a company not being able to generate enough cash flow to service its debt. This inability to "service" or pay its debts, can then lead to a deterioration of a company's credit rating. The lowering of a credit rating can result in a higher cost of debt capital. This higher cost of debt capital would ultimately be passed down to the ratepayers through rates, and thus would be detrimental to them.

In addition, higher debt to ownership or equity ratios can place a regulated company in the situation where equity investments may not occur unless a "risk premium" is offered in connection with the corporation's common stock. This increased premium cost associated with equity ownership would again be passed on to the ratepaying community through a higher return on equity and could result in higher rates.

Therefore, the Staff states that it is relevant, proper and appropriate that the Commission consider "equity balances" in the SUC application regardless of the fact that SUC is not seeking ratemaking treatment in connection with its existing or proposed capital

structure, because public interest issues are reasonably connected to acquisition applications through debt to equity relationships.

**STAFF'S SECOND POSITION IS THAT SOUTHERN UNION'S TRUST ORIGINATED
PREFERRED STOCK IS DEBT, NOT EQUITY**

Southern Union Company argues that the Commission has already decided that the trust originated preferred stock security, or "TOPRS" is an equity vehicle rather than a debt obligation. SUC relies on the finding of the Commission in Case No. GR-96-285. However, under well established caselaw, the decision of the Commission in the above referenced case is not binding on the Commission in this matter.

In State ex rel. Capital City Water v. Missouri Public Service Commission et al., 850 S.W. 2d 903 (Mo. App. W.D. 1993) page 911, the Court stated, in part, that:

"...the Commission cannot commit itself to a position that, because of varying conditions and occurrences over time, may require adjustment to protect ratepayers..."

Under this Court rationale it is clear that the Commission is not necessarily bound by a previous decision. Therefore, SUC cannot rely on a Commission decision that occurred in the past dealing with TOPRS.

The specifics of the Staff's analysis on TOPRS is that Southern Union has outstanding \$100,000,000 of 9.48% Trust Originated Preferred Securities (TOPRS or TOPRS preferred stock). Holders of Southern Union's TOPRS are entitled to receive cumulative cash interest payments at an annual rate of 9.48% payable quarterly in arrears on March 31, June 30, September 30 and December 31. Southern Union has the right to defer interest payments on the TOPRS for up to 20

consecutive quarters (extension periods). During the extension periods, interest on the TOPRS will continue to accrue at an annual rate of 9.48 percent compounded quarterly.

A liability is a claim to a company's assets by another entity and, once incurred, involves nondiscretionary future sacrifices of assets that must be satisfied on demand, at a specified or determinable date or on the occurrence of a specified event. While Southern Union can defer interest payments on its TOPRS stock up to a maximum of five years, the payments are nondiscretionary in that they must be made.

In contrast, equity is a residual interest – what remains after liabilities are deducted from assets – and depends significantly on the profitability of a company. A company may distribute assets resulting from income to its owners, but distributions to owners are discretionary. A company is generally not obligated to transfer assets to its owners except in liquidation. For example, Southern Union has no obligation to pay any dividends (and historically does not pay cash dividends) on its common stock.

Ultimately, the characterization of an instrument as equity or debt should rest on whether by buying the instrument in question, an investor is purchasing a direct participation in the long-term growth of the issuing corporation, or a stream of cash flows based on an agreed-upon rate.

For most financial instruments, the distinction between debt and equity is obvious. Common stock clearly is equity. Corporate bonds clearly are debt. Southern Union's TOPRS, with its primary characteristic of paying quarterly cash payments is almost identical to a bond (paying semiannual cash payments) and therefore should be classified as debt. It would be unreasonable to assume that the investors who purchased Southern Union's TOPRS stock did so with the intent of participating in the long-term growth of the Company as opposed to receiving the quarterly cash interest payment.

A clear example of why holders of Southern Union's TOPRS cannot be considered shareholders or owners of the company is illustrated in the Company's prospectus issued with the Securities and Exchange Commission in conjunction with the TOPRS issuance. The prospectus describes how a change in the tax deductibility of the interest payments on the TOPRS would lead to a "Tax Event." If such an event occurs, Southern Union can redeem the TOPRS at any time. The prospectus also describes how, in lieu of redeeming the TOPRS and paying cash to the holders, Southern Union could simply issue debt securities in lieu of a cash payment. In effect, a simple change in the tax law will transform TOPRS holders from preferred stock shareholders to creditors (bondholders). This singular example illustrates the inadequacy of Southern Union's position that TOPRS is equity.

Therefore for the foregoing reasons, Staff states that TOPRS was correctly excluded by the Commission as equity in paragraph 8 of the Order and this paragraph should not be removed, reconsidered or reheard as SUC requests.

Respectfully submitted,

DANA K. JOYCE
General Counsel



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Illinois Bar No. 3123645

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Certificate of Service

I hereby certify that copies of the foregoing have been mailed or hand-delivered to all counsel of record as shown on the service list below this 12th day of August, 1999.

A handwritten signature in cursive script, reading "Cliff E. Snodgrass", written over a horizontal line.

Service List
GM-2000-49
August 12, 1999

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