MEMORANDUM

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Missouri Public Service Commission

TO: Missouri Public Service Commission Official Case File
Case No. GM-2000-49, Southern Union Company

FROM: Ronald L. Bible, RLB
Financial Analysis Department

R. E. Schallenberg 7-29-99
Director - Utility Services Division / Date

Thomas R Schwarz, Jr. 7/29/99
Cliff Snodgrass 7-29-99
General Counsel's Office / Date

SUBJECT: Staff's Corrected Recommendation for disapproval 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.

DATE: July 28, 1999

Southern Union Company

Southern Union Company (SUC, Company) is a public utility engaged in providing services to customers in Missouri. The Company has filed an application requesting authority from the Missouri Public Service Commission (Commission) to acquire stock of Pennsylvania Enterprises, Inc. (PNT). PNT provides natural gas service to more than 153,000 customers in thirteen (13) counties in northeastern and central Pennsylvania. PNT also has several unregulated subsidiaries which provide energy-related products and services. SUC, a Delaware corporation, is authorized to conduct business in Missouri through its Missouri Gas Energy (MGE) operating division. MGE provides natural gas and natural gas distribution services to residential, commercial and industrial customers in Western Missouri. Southern Union states in the Application that:

> On June 7, 1999, SUC and PNT entered into an Agreement of Merger ("the Agreement") pursuant to which Southern Union has agreed to acquire PNT for approximately $500,000,000.
>
> In advance of the closing of the Merger, Southern Union proposes to acquire up to and including five percent (5%) of the outstanding shares of common stock of PNT, which, at recent market prices, would be an investment of approximately $17 million.

This response to Southern Union's Application is based only upon the information provided in the Company's Application and the accompanying attachments; the Staff has not had sufficient time to carefully study the matter. In that regard, Staff notes that the Company has been examining the project for quite some time. The merger announcement was made on June 7, 1999 and the Company has been performing due diligence prior to that date. Also, Staff notes that the Company's merger agreement with PNT gives them until December of 2000, approximately eighteen (18) months from the present, to gain regulatory approval.

Staff recommends denial of the Application as filed. Staff review of the Application, and discussions with Company representatives, indicate that, as filed, the Application does not provide sufficient,

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specific undertakings by the Company to ensure that the Project is not detrimental to the public interest in Missouri. In rate case proceedings, Southern Union has consistently taken the position that their capital structure is highly leveraged and because of this their shareholders deserve a risk premium on return on equity. The Application indicates the Company intends to borrow even more money for this request, which will increase their leverage and exacerbate the risk premium argument.

In its Application the Company shows a proforma financial scenario. This scenario shows the Company losing money because they are borrowing $12 million at 5.5%, yet only earning 3.97% on its investment. Furthermore the Company fails to show a scenario in which their offer does not result in a business combination with PNT. If the business combination between SUC and PNT does not occur, the stock price could retreat and Southern Union would be forced to liquidate their position at a loss. The Company's failure to recognize the negative consequences of this scenario also results in a failure to take precautions to ensure that this action is not detrimental to the public interest in Missouri.

Staff finds this particularly disturbing because this issue has been addressed with the Company in its previous applications, as well as in meetings and other discussions. In Case Nos. GM-98-425 and GM-99-323, the Company proposed a similar scenario and Staff expressed it's concerns, and recommended denial of those Applications. In discussions with the Company on June 13, 1999 regarding this merger, Staff again expressed its concerns, and referred the Company to conditions (attached) for this type of transaction as set forth in the conditions for Case No. GM-99-323. From that meeting, and subsequent conversations, Staff understood that the Company intended to comply with Staff's conditions. Review of its application indicates they have not.

Staff recommends that the Commission deny the Application as filed. If the Commission is inclined to approve the Application, Staff urges that it do so only on the conditions as attattached.

If, contrary to the Staff's recommendation in this proceeding, the Commission approves the Company's request, the Order should clearly state that by approving the stock purchase the Commission is not indicating its belief that the proposed Application in GM-2000-43 is consistent with the public interest pursuant to RSMo. § 393.150. Nothing in said Order granting approval of this Application shall be considered as a finding by the Commission as to whether the transaction in GM-2000-43 is consistent with the public interest.

The Staff respectfully requests that this matter be placed on the Commission's Agenda as soon as possible.

Attachment:

GM-2000-49 Conditions

Copies: Director - Utility Operations Division
Director – Research and Public Affairs
Manager - Financial Analysis Department
Office of the Public Counsel
Dennis K. Morgan, Southern Union Company
Director - Utility Services Division
Manager - Gas Department
General Counsel
Paul A. Boudreau, Company Counsel

GM-2000-49 CONDITIONS

1. Company shall be required to file complete financial documentation, **concurrent to** the action, for each investment, including but not limited to methods of finance; overall cost of the transaction; interest rate of borrowed funds; source of equity invested; correspondence with brokers and investment firms, etc. This documentation will include dated buy and sell orders for the specific investment. (OPC Condition A)

2. Company shall be required to file financial investment reports, such as monthly or quarterly, of the current status of **all** investments and investment activity. Content of these reports would include (but is not limited to) initial investment, current carrying value, any activity such as stock splits, dates of sale, etc. (OPC Condition B)

3. The Company must undertake to capture, retain and make available to regulatory authority the raw data needed to capture all direct and indirect costs associated with the Project: The Company should, at a minimum; maintain: a list of all persons involved in the Project; support personnel involved in the Project; the time spent by those personnel on the Project; a list of all support facilities or services used on the Project; and a list of all other expense incurred by the Company on the Project. Such other expense shall include but not be limited consultants, communication, travel and debt costs. The Company must file a report within thirty (30) days of the Commission order detailing the information that it presently has captured and the procedures it will use to capture this information in the future. Such information must be maintained and made available through the completion of the Company's next rate case. (OPC Condition C; Staff condition b)

4. The Company will represent that the Project will not affect the funding for the construction budget of its Missouri Gas Energy ("MGE") operating division for this fiscal year nor MGE's operational expenses necessary to provide safe and adequate service. Further, the Company must demonstrate that next year's construction budget for MGE will not be affected by this Project. This demonstration will include MGE's commitment to its safety program for the year ending June 30, 2000. The Company must agree that to meet its construction obligations it will, if necessary, liquidate a portion of the Project to meet its obligations. (OPC Condition D; Staff Condition a)

5. Missouri ratepayers will suffer no adverse effects from any initial investment or losses suffered on such investments through either an amortization of said losses directly to the operating income of MGE or via a reduction in retained earnings due to such losses. Company's capital structure (actual dollar levels and

percentage levels) will not be affected by losses on investments in determining the appropriate rate of return in the future. In order to ensure that the Project is not detrimental to the public interest, the Company must specify the steps which it will take to insulate Missouri ratepayers from such possible results. (OPC Condition E; Staff Condition d)

6. Southern Union Company and MGE will not seek an increase to its requested Return On Equity or overall Rate of Return, for Missouri operations, due to factors of, or relating to, actual leverage, percentage of leverage in the capital structure, risk associated with leverage, changes in cash or cash working capital, or any other real or perceived changes in risk profile due to these investments. Also, any adverse effects on Company's cost of debt will not be included in the calculation of Missouri-jurisdiction Rate of Return of cost of service. No adverse effect of the Project will be included in capitalization of AFUDC in the Company's rate base and/or under presently authorized AAOs. The Company will represent that, if the Project requires interim financing, that its lowest cost of debt will be assigned to regulated projects, and higher cost debt assigned to unregulated projects. (OPC Condition F; Staff Condition C)

7. 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 the company as compared to all other securities or claims upon the assets of the company. Owners 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. (OPC Condition G)