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September 7, 1999

D. BRUCE MAY, JR.
850-425-5607

Internet Address:
dbmay@hklaw.com

VIA HAND DELIVERY

Blanca S. Bayo
Director, Division of Records & Reporting
Florida Public Service Commission
Capital Circle Office Center
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

RECORDS AND REPORTING

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991337-BU

Re: In re: Application of Southern Union Company for Authority to Issue and Sell Securities Pursuant to Section 366.04, Florida Statutes and Chapter 25-8, Florida Administrative Code; and Request for Approval to Borrow Funds for Short-Term Financing Purposes.

Dear Ms. Bayo:

Enclosed for filing on behalf of Southern Union Company are the original and five (5) copies of its Application for Authority to Issue and Sell Securities Pursuant to Section 366.04, Florida Statutes and Chapter 25-8, Florida Administrative Code; and Request for Approval to Borrow Funds for Short-term Financing Purposes and exhibits thereto. A diskette containing the application in Wordperfect format has been provided.

For our records, please acknowledge your receipt of this filing on the enclosed copy of this letter. Thank you for your consideration.

Sincerely,

HOLLAND & KNIGHT LLP

D. Bruce May
D. Bruce May

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Blanca S. Bayo
September 7, 1999
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DBM:kjg
Enclosure

cc: Andrew Maurey, Public Utility Supervisor

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Application of Southern Union
Company for Authority to Issue and Sell
Securities Pursuant to Section 366.04,
Florida Statutes, and Chapter
25-8, Florida Administrative Code; and
Request for Approval to Borrow Funds
for Short-term Financing Purposes

Docket No. 991337-64
Filed: September 7, 1999

**APPLICATION OF SOUTHERN UNION COMPANY FOR
AUTHORITY TO ISSUE AND SELL SECURITIES PURSUANT
TO SECTION 366.04, FLORIDA STATUTES AND
CHAPTER 25-8, FLORIDA ADMINISTRATIVE CODE;
AND REQUEST FOR APPROVAL TO BORROW FUNDS
FOR SHORT-TERM FINANCING PURPOSES**

Southern Union Company ("Southern Union"), by and through undersigned counsel, pursuant to Section 366.04, Florida Statutes, and Chapter 25-8, Florida Administrative Code, hereby files this application for authority to issue and sell securities, and to borrow funds for short-term financing purposes during the twelve month period ending October 31, 2000. In support of its application, Southern Union states:

1. Applicant Information

The name and principal business address of the applicant are as follows:

Southern Union Company
504 Lavaca Street, Suite 800
Austin, Texas 78701.

Southern Union is a public utility engaged in the distribution of natural gas to the public. As of March 31, 1999, Southern Union had approximately \$1.1 billion in assets and three natural gas divisions which provide service to more than one

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10712 SEP-7 99

FPSC-RECORDS/REPORTING

million customers in Texas, Missouri and Florida.¹ Southern Union conducts its natural gas operations in Florida through its Atlantic Utilities Division doing business as South Florida Natural Gas ("SFNG"), which provides service to approximately 5,500 customers in the vicinity of New Smyrna Beach, Florida. Thus, Southern Union is regulated by the Florida Public Service Commission (the "Commission") as a public utility pursuant to Chapter 366, Florida Statutes.

2. Incorporation

Southern Union was incorporated in Delaware in 1932. Southern Union is authorized to transact business in Florida, Texas, Missouri and Pennsylvania.

3. Persons Authorized To Receive Notices and Communications

The names and addresses of the persons authorized to receive notices and communications with respect to this application are as follows:

Dennis K. Morgan
Senior Vice-President – Legal and Secretary
Southern Union Company
504 Lavaca Street, Suite 800
Austin, Texas 78701
(517) 370-8310

D. Bruce May
Karen D. Walker
HOLLAND & KNIGHT LLP
P.O. Drawer 810
315 South Calhoun Street, Suite 600
Tallahassee, Florida 32302 (32301)
(850) 224-7000.

¹ Through its Southern Union Gas Division, Southern Union serves approximately 513,000 customers in Texas, including customers in the cities of Austin, El Paso, Brownsville, Galveston, and Port Arthur. The Missouri Gas Energy Division serves approximately 484,000 customers in western Missouri, including customers in the cities of Kansas City, St. Joseph, Joplin and Monett.

4. Capital Stock and Funded Debt

Southern Union and its consolidated financing subsidiaries are authorized by their organizational documents, including Southern Union's Restated Certificate of Incorporation, as amended to date, to issue common stock, and preferred stock of Southern Union, and trust preferred securities of certain financing subsidiary business trusts as follows:

- (a) Brief Description: Currently, the authorized capital stock of Southern Union consists of: (i) 50,000,000 shares of Southern Union Common Stock (\$1 par value per share); and (ii) 1,500,000 shares of Southern Union Cumulative Preferred Stock (no par value). The authorized securities of Southern Union Financing I ("Subsidiary Trust"), a consolidated wholly-owned subsidiary of Southern Union, consist of: (i) shares of common securities, all of which are issued, outstanding and held by Southern Union; and (ii) 4,000,000 shares of Trust Originated Preferred Securities.
- (b) Amount Authorized: The amount authorized is set forth above.
- (c) Amount Outstanding: As of June 30, 1999 there were 31,188,037 shares of Southern Union Common Stock issued and outstanding. No shares of Southern Union Cumulative Preferred Stock are issued or outstanding. As of June 30, 1999, 4,000,000 shares of Trust Originated Preferred Securities ("Preferred Securities") issued by the Subsidiary Trust were outstanding with a face amount of \$100,000,000 (\$25 par value per share). In connection with the issuance of the Preferred Securities and the related purchase by Southern

Union of all of the Subsidiary Trust's common securities ("Common Securities"), Southern Union issued the Subsidiary Trust \$103,092,000 principal amount of its 9.48% Subordinated Deferrable Interest Notes, due 2025 ("Subordinated Notes"). Both the Preferred Securities and the Subordinated Notes bear a rate of 9.48%.

- (d) Amount Held As Reacquired Securities: None.
- (e) Amount Pledged: None.
- (f) Amount Owned By Affiliated Corporations: None.
- (g) Amount Held In Funds: None.

The funded consolidated indebtedness of Southern Union not held by the Subsidiary Trust is as follows:

- (a) Brief Description: On January 31, 1994, 475,000 notes of 7.6% Senior Debt Securities ("Senior Notes") were issued for a face amount of \$475,000,000. These notes come due in February, 2024. Since the initial issuance of the 475,000 Senior Notes, 110,485 Senior Notes (with a face value of \$110,485,000) have been repurchased and retired.
- (b) Amount Authorized: The amounts authorized are set forth above.
- (c) Amount Outstanding: As of June 30, 1999, there are 364,515 of the Senior Notes outstanding, which reflects an outstanding balance of \$364,515,000.
- (d) Amount Held As Reacquired Securities: None.

- (e) Amount Pledged: None.
- (f) Amount Owned By Affiliated Corporations: None.
- (g) Amount Held In Funds: None.

5. Proposed Transactions

Southern Union seeks authority to issue and sell and/or exchange any combination of the long-term debt and equity securities described below and/or to assume liabilities or obligations as guarantor, endorser, or surety in an aggregate amount not to exceed \$1 billion during the twelve month period from November 1, 1999 through October 31, 2000. Of this amount, Southern Union common stock will constitute at least \$310,000,000. In addition, Southern Union seeks authority to borrow up to \$200,000,000 for short-term financing purposes.

The long-term debt securities may include first mortgage bonds, medium-term notes, debentures, convertible or exchangeable debentures, notes, convertible or exchangeable notes, or other straight debt or hybrid debt securities, whether secured or unsecured, with maturities ranging from one to fifty years. Southern Union may enter into related options, rights, interest rate swaps or other derivative instruments.

The equity securities may include common stock, preferred stock, preference stock, convertible preferred or preference stock, or warrants, options or rights to acquire such securities, or other equity securities, with such par values, terms and conditions and relative rights and preferences as deemed appropriate by Southern Union and any consolidated financing subsidiary, and as are permitted by

Southern Union's Restated Certificate of Incorporation, as amended from time to time, and by any such financing subsidiary's organizational documents.

Any such consolidated financing subsidiary of Southern Union may issue preferred securities similar to that currently outstanding, whereby Southern Union would establish and make an equity investment in a special purpose limited partnership, trust or other entity. Southern Union, a wholly-owned subsidiary of Southern Union or Southern Union designees would act as the general partner, trustee or trustees, or similar manager of the entity. The entity would offer preferred securities to the public and lend the proceeds to Southern Union. Southern Union would issue debt securities to the entity equal to the aggregate of its equity investment and the amount of preferred securities issued. Southern Union may also guarantee, among other things, the distributions to be paid by the affiliated entity to the holders of the preferred securities.

The interest rate Southern Union could pay on debt securities will vary depending on the type of debt instruments and the terms thereof, including specifically the length of maturity as well as market conditions. On August 23, 1999, a new issue of 10-year senior notes of Southern Union would have carried a yield to maturity of approximately 8.4%. The dividend rate for preferred securities is similarly affected by the terms of the offering. On September 3, 1999, a new issue of thirty-year tax deductible preferred securities of Southern Union would have carried a dividend yield of approximately 9%.

In addition, Southern Union may from time to time issue instruments of guaranty, collateralize debt and other obligations, issue securities, and arrange for the issuance of letters of credit and guaranties, in any such case to be issued by or on behalf of one of more of its subsidiaries or affiliates for the benefit of Southern Union's utility operations, or in connection with other financings by Southern Union and its subsidiaries, or on its or any of their behalf.

Southern Union will file a consummation report with the Commission in compliance with Rule 25-8.009, Florida Administrative Code, within 90 days after the end of any fiscal year in which it issues securities.

6. Purposes For Which Securities Are To Be Issued

The net proceeds to be received from the issuance and sale and/or exchange of the additional long-term debt and equity securities will be added to Southern Union's general funds and will be used in connection with the merger of Pennsylvania Enterprises, Inc. ("PNT") into Southern Union,² to reacquire, by

² PNT is a Pennsylvania corporation that provides natural gas service to more than 153,000 customers in thirteen counties in northeastern and central Pennsylvania through its subsidiaries, PG Energy, Inc. ("PG Energy") and Honesdale Gas Company ("Honesdale"). On June 7, 1999, Southern Union and PNT entered into an Agreement of Merger (the "Agreement") pursuant to which PNT and its utility subsidiaries will merge into Southern Union for approximately \$500 million, including the assumption of PNT long-term indebtedness, as more particularly described herein and in the Agreement. The Agreement calls for each share of PNT's approximately 11 million outstanding shares of common stock to be converted into Southern Union stock having a value of \$32, plus \$3 in cash. The number of shares received for each PNT share will depend on the average closing price of Southern Union's stock for a period of ten consecutive trading days ending on the third day before the transaction is completed, as explained in Section 3.1 of the Agreement. As of the Effective Time, as described in Section 2.2. of the Agreement, PNT will be merged with and into Southern Union, which will be the surviving corporation. Immediately thereafter, Honesdale will be merged with and into PG Energy which immediately will be merged with and into Southern Union. Following the merger, Southern Union will provide natural gas to customers currently served by PG Energy and Honesdale through Southern Union's Pennsylvania Division. The PNT merger is conditioned upon, among other things, approvals or concurrence of various state and federal regulatory agencies, including the Commission's approval of this Application.

redemption, purchase, exchange or otherwise, any of its outstanding debt securities and equity securities as market conditions warrant; to repay all or a portion of any maturing long-term debt obligations; to repay all or a portion of short-term bank borrowings; and/or for other general corporate purposes. Excess proceeds, if any, will be temporarily invested in short-term instruments pending their application to the foregoing purposes.

Southern Union has for some time had the goal of selected growth and expansion within the utility industry including the acquisition of natural gas distribution or transmission businesses. Over the past eight years, Southern Union has acquired a number of such businesses, adding approximately 545,000 customers to its operations. The PNT merger will further contribute to Southern Union's goal of selected growth and expansion. Up to \$390,000,000 of equity and \$90,000,000 of debt securities as previously described will be used to accomplish this merger, which will be transparent to Southern Union's Florida customers served by SFNG.

In connection with the PNT merger, Southern Union may assume and/or issue up to \$175,000,000 of debt securities as described in the previous section to refinance certain short-term debt of PNT, the current portion of long-term debt of PNT, and depending on market conditions and the terms and covenants for each issue, assume and/or refinance some or all of the long-term debt of PNT. Some or all of these PNT debt securities, if assumed upon closing of the PNT merger, may be refinanced after such merger.

Southern Union maintains a continuous construction program, principally for gas distribution facilities. Southern Union estimates that construction expenditures under its 1999-2000 construction program will approximate \$90,000,000.

Southern Union's 9.48% preferred securities (face value of \$100,000,000) issued in May, 1995, become callable by Southern Union in May, 2000. Depending on market conditions, any mixture of debt, preferred or equity may be issued to redeem any, all or none of those securities.

Under future market conditions, the interest rate on new issue long-term debt or the dividend rate on new issue preferred securities of Southern Union may be such that it becomes economically attractive to reacquire a portion or all of certain of its long-term debt securities or equity securities, providing an opportunity for Southern Union to reduce interest or dividend expense, or simplify or reduce covenant restrictions and/or requirements. Any reduction in expense or simplification of covenant restrictions would be beneficial to the ratepayers and, with proper regulatory treatment, would not be detrimental to Southern Union's shareholders. Other important considerations in making such a decision would include an assessment of anticipated future interest and dividend rates and Southern Union's ability to raise enough new capital to finance its expansion and construction programs while currently pursuing any refinancing opportunities.

Remaining funds would be used for general corporate purposes that may include, but not be limited to, investments in new technologies to provide quality

service to Southern Union's customers, development of related energy businesses or expansion opportunities in the gas distribution business.

Southern Union, from time to time, may issue instruments of guaranty, collateralized debt and other obligations, issue securities and arrange for the issuance of letters of credit and guaranties by or on behalf of itself or of one or more of its subsidiaries or affiliates.

Southern Union will require short-term borrowing not to exceed \$200,000,000 to provide funds for working capital needs, temporary financing of its construction program and capital commitments, temporary funding of maturing or called long-term debt or preferred securities, and any other corporate purposes. Southern Union's working capital requirements arise largely from the seasonality of its natural gas business. Southern Union's borrowing requirements of up to \$200,000,000 will be priced based on LIBOR and/or the prime rate of interest, and thus will fluctuate with market conditions.

7. Lawful Object and Purpose

The PNT merger presents opportunities for numerous benefits to Southern Union and its customers. Economies may result through consolidation of "public company" functions such as director and shareholder meetings, annual reports and Securities and Exchange Commission ("SEC") filing requirements. The PNT merger also will allow Southern Union to diversify its risk associated with any one region's weather and economic conditions. This should help reduce earnings fluctuations. The merger will provide Southern Union an opportunity to expand

into the electric marketing business and possibly transfer this experience to its other markets. The PNT merger will also increase the public float of Southern Union's common stock, which should result in greater investment research coverage of the Company.

As previously noted, the PNT merger will be entirely transparent to Southern Union's Florida customers served by SFNG. The PNT merger will not affect SFNG's service to its Florida customers, except to the extent that it should enhance the financial viability of Southern Union. SFNG's customers will continue to experience quality day-to-day natural gas service at reasonable rates approved pursuant to SFNG's tariff on file with the Commission.

In addition to the reasons described above, the proposed issues are consistent with the proper performance by Southern Union of service as a public utility, will better enable Southern Union to perform that service, and are necessary and appropriate for such purpose and/or other corporate purposes.

8. Counsel Passing On Legality of the Proposed Issues

The counsel that will pass on the legality of the proposed issues is:

Fleischman and Walsh, L.L.P.
Suite 600
1400 Sixteenth Street, N.W.
Washington, D.C. 20036
Attention: Stephen A. Bouchard, Esq.

As to matters of Florida law, Fleishman and Walsh, L.L.P. will rely on

Holland & Knight LLP
P.O. Drawer 810
Tallahassee, Florida 32302.

9. Filings With Other State or Federal Regulatory Bodies

If required, a Registration Statement with respect to each public sale of securities hereunder subject to the Securities Act of 1933, as amended, will be filed with the SEC. In addition, certain state securities or "blue sky" laws may require the filing of consents to service of process or other documents with applicable state securities commissions.

10. Control or Ownership

There is no measure of control or ownership exercised by or over Southern Union by any other public utility.

11. Exhibits

Composite Exhibit "A" and Composite Exhibit "B" are attached hereto as required by Rule 25-8.003, Florida Administrative Code. Composite Exhibit "A" consists of: (a) Southern Union's financial statements and accompanying footnotes as they appear in Southern Union's Annual Report on Form 10-K as filed with the SEC for the fiscal year ended June 30, 1998; and (b) Southern Union's financial statements and accompanying footnotes as they appear in Southern Union's most recent Quarterly Report on Form 10-Q (March 31, 1999), as filed with the SEC. Exhibit "B" consists of Southern Union's sources and uses of funds forecast, including a construction budget. In addition, attached hereto as Exhibit "C" is a copy of the Agreement between Southern Union and PNT.

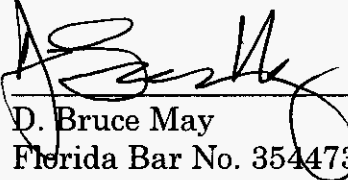
WHEREFORE, Southern Union respectfully requests that the Commission:

- (a) authorize Southern Union to issue and sell and/or exchange any combination of the long-term debt and equity securities described in this

Application and/or to assume liabilities or obligations as guarantor, endorser, or surety in an aggregate amount not to exceed \$1 billion and to borrow up to \$200,000,000 for short-term financing purposes during the twelve month period from November 1, 1999 through October 31, 2000; and

(b) grant such other relief as the Commission deems appropriate.

Respectfully submitted this 7th day of September, 1999.



D. Bruce May
Florida Bar No. 354473
Karen D. Walker
Florida Bar No. 0982921
HOLLAND & KNIGHT LLP
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315 South Calhoun Street, Suite 600
Tallahassee, Florida 32302 (32301)
(850) 224-7000

**Attorneys for Southern Union
Company**

TAL1 #200876 v4

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549**

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Fiscal Year Ended June 30, 1998

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File No. 1-6407

SOUTHERN UNION COMPANY

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

75-0571592

(I. R. S. Employer
Identification No.)

**504 Lavaca Street, Eighth Floor
Austin, Texas**

(Address of principal executive offices)

78701

(Zip Code)

Registrant's telephone number, including area code: **(512) 477-5852**

Securities Registered Pursuant to Section 12(b) of the Act:

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
Common Stock, par value \$1 per share	New York Stock Exchange

Securities Registered Pursuant to Section 12(g) of the Act: None

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

The aggregate market value of the voting stock held by non-affiliates of the registrant on September 14, 1998, was \$323,399,975. The number of shares of the registrant's Common Stock outstanding on September 14, 1998 was 28,210,385.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's proxy statement for its annual meeting of stockholders to be held on November 12, 1998, are incorporated by reference into Part III.

PART I

ITEM 1. *Business.*

Introduction

Southern Union Company (*Southern Union* and together with its subsidiaries, the *Company*) was incorporated under the laws of the State of Delaware in 1932. Southern Union is one of the top 15 gas utilities in the United States, as measured by number of customers. The Company's principal line of business is the distribution of natural gas as a public utility through Southern Union Gas, Missouri Gas Energy (MGE) and Atlantic Utilities, doing business as South Florida Natural Gas (SFNG), each of which is a division of Southern Union. Southern Union Gas, headquartered in Austin, Texas, serves 511,000 residential, commercial, industrial, agricultural and other customers in Texas (including the cities of Austin, Brownsville, El Paso, Galveston, Harlingen, McAllen and Port Arthur). MGE, headquartered in Kansas City, Missouri, serves 482,000 customers in central and western Missouri (including the cities of Kansas City, St. Joseph, Joplin and Monett). The diverse geographic area of the Company's natural gas distribution systems reduces the sensitivity of Southern Union's operations to weather risk and local economic conditions. See *Acquisitions*.

Subsidiaries of Southern Union have been established to support and expand natural gas sales and to capitalize on the Company's gas energy expertise. These subsidiaries market natural gas to end-users, operate natural gas pipeline systems, distribute propane and sell commercial gas air conditioning and other gas-fired engine-driven applications. By providing "one-stop shopping," the Company can serve its various customers' specific energy needs, which encompass substantially all of the natural gas distribution and sales businesses from natural gas sales to specialized energy consulting services. The Company distributes propane to 8,500 and 800 customers in Texas and Florida, respectively. Additionally, certain subsidiaries own or hold interests in real estate and other assets, which are primarily used in the Company's utility business. Central to all of the Company's present businesses and strategies is the sale and transportation of natural gas. See *Company Operations and Investments*.

The Company is a sales and market-driven energy company whose management is committed to achieving profitable growth of its utility businesses in an increasingly competitive business environment. Management's strategies for achieving these objectives principally consist of: (i) promoting new sales opportunities and markets for natural gas and propane; (ii) enhancing financial and operating performance; and (iii) expanding the Company through development of existing utility businesses and selective acquisition of new utility businesses. Management develops and continually evaluates these strategies and their implementation by applying their experience and expertise in analyzing the energy industry, technological advances, market opportunities and general business trends. Each of these strategies, as implemented throughout the Company's existing businesses, reflects the Company's commitment to its core gas utility business.

The Company has a goal of selected growth and expansion, primarily in the utilities industry. To that extent, the Company intends to consider, when appropriate, and if financially practicable to pursue, the acquisition of other utility distribution or transmission businesses. The nature and location of any such properties, the structure of any such acquisitions, and the method of financing any such expansion or growth will be determined by management and the Southern Union Board of Directors. See *Management's Discussion and Analysis of Results of Operations and Financial Condition (MD&A) -- Cautionary Statement Regarding Forward-Looking Information*.

Acquisitions

Effective December 31, 1997, Southern Union acquired Atlantic Utilities Corporation and Subsidiaries (Atlantic) for 755,650 pre-split shares of common stock valued at \$18,041,000 and cash of \$4,436,000. Atlantic is operated as SFNG, a natural gas division of Southern Union, and Atlantic Gas Corporation, a propane subsidiary of the Company. Atlantic currently serves 4,800 customers in central Florida.

On July 23, 1997, two subsidiaries of Southern Union acquired a 42% equity ownership in a natural gas distribution company and other related operations in Piedras Negras, Mexico for \$2,700,000. The natural gas distribution company serves 17,500 customers and is across the border from the Company's Eagle Pass, Texas service area.

On September 8, 1997, the Company purchased a 45-mile intrastate pipeline, which will augment the Company's gas supply to the city of Eagle Pass and, subject to necessary regulatory approvals, ultimately Piedras Negras.

Company Operations and Investments

The Company's principal line of business is the distribution of natural gas through its Southern Union Gas, MGE and SFNG divisions. Southern Union Gas provides service to a number of communities and rural areas in Texas, including the municipalities of Austin, Brownsville, El Paso, Galveston, Harlingen, McAllen and Port Arthur. MGE provides service to various cities and communities in central and western Missouri including Kansas City, St. Joseph, Joplin and Monett. SFNG provides service to various cities and communities in central Florida including New Smyrna Beach and Edgewater. SFNG had gas sales of 145 MMcf during the six months ended June 30, 1998 to 4,000 customers. The Company's gas utility operations are generally seasonal in nature, with a significant percentage of its annual revenues and earnings occurring in the traditional winter heating season.

Mercado Gas Services Inc. (Mercado), a wholly-owned subsidiary of Southern Union, markets natural gas to approximately 200 commercial and industrial customers. Mercado's sales and purchasing activities are made through short-term and long-term contracts. These contracts and business activities are not subject to direct rate regulation. Mercado had gas sales of 18,352 MMcf and 18,485 MMcf for the year ended June 30, 1998 and 1997, respectively.

Southern Transmission Company (Southern), a wholly-owned subsidiary of Southern Union, owns and operates intrastate pipelines which connect the cities of Lockhart, Luling, Cuero, Shiner, Yoakum, and Gonzales, Texas, as well as a line that provides gas to an industrial customer in Port Arthur, Texas. Southern also owns a transmission line which supplies gas to the community of Sabine Pass, Texas. On September 8, 1997, Southern purchased a 45-mile intrastate pipeline which will augment gas supply to the city of Eagle Pass, Texas, and ultimately into Piedras Negras, Mexico. Southern transported 915 MMcf and 707 MMcf of gas for the year ended June 30, 1998 and 1997, respectively.

Norteño Pipeline Company (Norteño), a wholly-owned subsidiary of Southern Union, operates interstate pipeline systems principally serving the Company's gas distribution properties in the El Paso, Texas area. Norteño transported a combined 11.49 billion cubic feet (Bcf) for the city of Juarez, Mexico and the Samalayuca Power Plant in north Mexico in fiscal 1998. Norteño transported 11,538 MMcf and 17,070 MMcf of gas for the year ended June 30, 1998 and 1997, respectively.

SUPro Energy Company (SUPro), a wholly-owned subsidiary of Southern Union, provides propane gas services to 8,500 customers located principally in El Paso and Alpine, Texas. SUPro sold 5,125,000 and 2,417,000 gallons of propane in 1998 and 1997, respectively.

Atlantic Gas Corporation, a wholly-owned subsidiary of Southern Union, provides propane gas services to 800 customers located in and around the communities of New Smyrna Beach, Lauderhill and Dunnellon, Florida. Atlantic Gas Corporation sold 633,000 gallons of propane during the six months ended June 30, 1998.

Energy WorX, a wholly-owned subsidiary of Southern Union, provides interactive computer-based training for the natural gas transmission and distribution industry.

Southern Union Total Energy Systems, Inc., a wholly-owned subsidiary of Southern Union, markets and sells commercial gas air conditioning, irrigation pumps and other gas-fired engine-driven applications and related services.

Southern Union Energy International, Inc. (SUEI) and Southern Union International Investments, Inc. (Investments), both wholly-owned subsidiaries of Southern Union, participate in energy-related projects internationally. Energia Estrella del Sur, S. A. de C. V. (Estrella), a wholly-owned Mexican subsidiary of SUEI and Investments, seek to participate in energy-related projects in Mexico. On July 23, 1997, Estrella acquired a 42% equity ownership in a natural gas distribution company and other related operations which currently serves 17,500 customers in Piedras Negras, Mexico, across the border from Southern Union Gas' Eagle Pass, Texas service area.

ConTigo, Inc., a wholly-owned subsidiary of Southern Union formed in January 1996, provides centralized call center services for the majority of the Texas service areas.

During fiscal 1998, the Company made an equity investment in a leading developer of advanced gas turbine-driven generator technology. The Company also holds investments in commercially developed real estate in Austin, El Paso,

Harlingen and Kansas City through Southern Union's wholly-owned subsidiary, Lavaca Realty Company (Lavaca Realty).

Competition

The Company's gas distribution divisions are not currently in significant direct competition with any other distributors of natural gas to residential and small commercial customers within their service areas. However, in recent years, certain large volume customers, primarily industrial and significant commercial customers, have had opportunities to access alternative natural gas supplies and, in some instances, delivery service from other pipeline systems. The Company has offered transportation arrangements to customers who secure their own gas supplies. These transportation arrangements, coupled with the efforts of Southern Union's unregulated marketing subsidiary, Mercado, enable the Company to provide competitively priced gas service to these large volume customers. In addition, the Company has successfully used flexible rate provisions, when needed, to retain customers who may have access to alternative energy sources.

As energy providers, Southern Union Gas, MGE and SFNG have historically competed with alternative energy sources, particularly electricity and also propane, coal, natural gas liquids and other refined products available in the Company's service areas. At present rates, the cost of electricity to residential and commercial customers in the Company's service areas generally is higher than the effective cost of natural gas service. There can be no assurance, however, that future fluctuations in gas and electric costs will not reduce the cost advantage of natural gas service. The cost of expansion for peak load requirements of electricity in some of Southern Union Gas' and MGE's service areas has historically provided opportunities to allow energy switching to natural gas pursuant to integrated resource planning techniques. Electric competition has responded by offering equipment rebates and incentive rates.

Competition between the use of fuel oils, natural gas and propane, particularly by industrial, electric generation and agricultural customers, has also increased due to the volatility of natural gas prices and increased marketing efforts from various energy companies. While competition between such fuels is generally more intense outside the Company's service areas, this competition affects the nationwide market for natural gas. Additionally, the general economic conditions in its service areas continue to affect certain customers and market areas, thus impacting the results of the Company's operations.

Gas Supply

The low cost of natural gas service is dependent upon the Company's ability to contract for natural gas using favorable mixes of long-term and short-term supply arrangements and favorable transportation contracts. The Company has been directly acquiring its gas supplies since the mid-1980s when interstate pipeline systems opened their systems for transportation service. The Company has the organization, personnel and equipment necessary to dispatch and monitor gas volumes on a daily and even hourly basis to ensure reliable service to customers.

The Federal Energy Regulatory Commission (FERC) required the "unbundling" of services offered by interstate pipeline companies beginning in 1992. As a result, gas purchasing and transportation decisions and associated risks have been shifted from the pipeline companies to the gas distributors. The increased demands on distributors to effectively manage their gas supply in an environment of volatile gas prices provides an advantage to distribution companies such as Southern Union who have demonstrated a history of contracting favorable and efficient gas supply arrangements in an open market system.

The majority of Southern Union Gas' 1998 gas requirements for utility operations were delivered under long-term transportation contracts through five major pipeline companies. The majority of MGE's 1998 gas requirements were delivered under short- and long-term transportation contracts through four major pipeline companies. The majority of SFNG's 1998 gas requirements were delivered under a management supply contract through one major pipeline company. These contracts have various expiration dates ranging from 1999 through 2018. Southern Union Gas also purchases significant volumes of gas under long- and short-term arrangements with suppliers. The amounts of such short-term purchases are contingent upon price. Southern Union Gas, MGE and SFNG all have firm supply commitments for all areas that are supplied with gas purchased under short-term arrangements. MGE also holds contract rights to over 16 Bcf of storage capacity to assist in meeting peak demands.

Gas sales and/or transportation contracts with interruption provisions, whereby large volume users purchase gas with the understanding that they may be forced to shut down or switch to alternate sources of energy at times when the gas is needed for higher priority customers, have been utilized for load management by Southern Union and the gas

industry as a whole for many years. In addition, during times of special supply problems, curtailments of deliveries to customers with firm contracts may be made in accordance with guidelines established by appropriate federal and state regulatory agencies. There have been no supply-related curtailments of deliveries to Southern Union Gas, MGE or SFNG utility sales customers during the last ten years.

During fiscal 1997, the Company was impacted by significant increases in natural gas prices. The following table shows, for each of the Company's principal utility service areas, the percentage of gas utility revenues and sales volume for the years ended June 30, 1998 and 1997 and the average cost per thousand cubic feet (Mcf) of gas in 1998 and 1997.

<u>Service Area</u>	<u>Percent of Gas Utility Revenues</u>		<u>Percent of Gas Utility Sales Volume</u>		<u>Average Cost Per Mcf</u>	
	<u>1998</u>	<u>1997</u>	<u>1998</u>	<u>1997</u>	<u>1998</u>	<u>1997</u>
Southern Union Gas						
Austin and South Texas	12	12	11	11	\$ 3.14	\$ 3.47
El Paso and West Texas	13	13	17	16	2.67	3.36
Rio Grande Valley	4	4	4	3	3.23	3.90
Other	<u>5</u>	<u>6</u>	<u>6</u>	<u>6</u>	3.02	3.33
	34	35	38	36		
Missouri Gas Energy	<u>66</u>	<u>65</u>	<u>62</u>	<u>64</u>	4.05	4.08
	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>		

The Company is committed under various agreements to purchase certain quantities of gas in the future. At June 30, 1998, the Company has purchase commitments for certain quantities of gas at variable, market-based prices. These market-based price commitments have an annual value of \$45,900,000 for Southern Union Gas and \$65,900,000 for MGE. SFNG has no market-based price commitments at June 30, 1998. The Company's purchase commitments may extend over a period of several years depending upon when the required quantity is purchased. The Company has purchase gas tariffs in effect for all its utility service areas that provide for recovery of its purchase gas costs under defined methodologies.

In August 1997, the Missouri Public Service Commission (MPSC) issued an order authorizing MGE to begin making semi-annual purchase gas adjustments (PGA) in November and April, instead of more frequent adjustments as in the past. Additionally, the order authorized MGE to establish an Experimental Price Stabilization Fund for purposes of procuring natural gas financial instruments to hedge a minimal portion of its gas purchase costs for the winter heating season. The cost of purchasing these financial instruments and any gains derived from such activities are passed on to the Missouri customers through the PGA. Accordingly, there is no earnings impact as a result of the use of these financial instruments. These procedures help stabilize the monthly heating bills for Missouri customers. The Company believes it bears minimal risk under the authorized transactions.

The MPSC approved a three year, experimental gas supply incentive plan for MGE effective July 1, 1996. Under the plan, the Company and MGE's customers share in certain savings below benchmark levels of gas costs achieved as a result of the Company's gas procurement activities. Likewise, if natural gas is acquired above benchmark levels, both the Company and customers share in such costs. For the year ended June 30, 1998 and 1997, the incentive plan achieved a reduction of overall gas costs of \$9,200,000 and \$10,200,000, respectively, resulting in savings to Missouri customers of \$5,100,000 and \$5,600,000, respectively. The Company recorded revenues of \$4,100,000 and \$4,600,000 in 1998 and 1997, respectively, under this plan. There can be no assurance that this or any similar plan will be approved by the MPSC for MGE after this plan expires on July 1, 1999.

Utility Regulation and Rates

The Company's rates and operations are subject to regulation by local, state and federal authorities. In Texas, municipalities have primary jurisdiction over natural gas rates within their respective incorporated areas. Rates in adjacent environs and appellate matters are the responsibility of the Railroad Commission of Texas. In Missouri, natural gas rates are established by the MPSC on a system-wide basis. In Florida, natural gas rates are established by the Florida Public Service Commission on a system-wide basis. The FERC and the Railroad Commission of Texas have jurisdiction over rates, facilities and services of Norteño and Southern, respectively.

The Company holds non-exclusive franchises with varying expiration dates in all incorporated communities where it is necessary to carry on its business as it is now being conducted. In the five largest cities in which the Company's

utility customers are located, such franchises expire as follows: Kansas City, Missouri in 1998; El Paso, Texas in 2000; Austin, Texas in 2006; and Port Arthur, Texas in 2013. The franchise in St. Joseph, Missouri is perpetual. The Company fully expects these franchises to be renewed upon their expiration.

Gas service rates are established by regulatory authorities to permit utilities the opportunity to recover operating, administrative and financing costs, and the opportunity to earn a reasonable return on equity. Gas costs are billed to customers through purchase gas adjustment clauses which permit the Company to adjust its sales price as the cost of purchased gas changes. This is important because the cost of natural gas accounts for a significant portion of the Company's total expenses. The appropriate regulatory authority must receive notice of such adjustments prior to billing implementation.

The Company must support any service rate changes to its regulators using a historic test year of operating results adjusted to normal conditions and for any known and measurable revenue or expense changes. Because the regulatory process has certain inherent time delays, rate orders may not reflect the operating costs at the time new rates are put into effect.

The monthly customer bill contains a fixed service charge, a usage charge for service to deliver gas, and a charge for the amount of natural gas used. While the monthly fixed charge provides an even revenue stream, the usage charge increases the Company's annual revenue and earnings in the traditional heating load months when usage of natural gas increases. In recent years, the majority of the Company's rate increases in Texas have resulted in increased monthly fixed charges which help stabilize earnings. Weather normalization clauses, in place in Austin, El Paso service area cities other than the City of El Paso, Galveston, Port Arthur and two other service areas in Texas, also help stabilize earnings. The city of El Paso had approved implementation of a weather normalization clause effective September 1, 1996, but rescinded the clause effective February 1, 1997.

On August 21, 1998, MGE was notified by the MPSC of its decision to grant a \$13,300,000 annual increase to revenue effective on September 2, 1998. The MPSC Rate Order reflected a 10.93% return on common equity. The Rate Order, however, disallowed certain previously recorded deferred costs requiring a non-cash write-off of \$2,221,000. Though the Company has requested a rehearing on significant portions of these disallowances, generally accepted accounting principles require the Company to immediately record this charge to earnings which Southern Union did as of June 30, 1998.

On April 13, 1998 Southern Union Gas filed for a \$2,228,000 request for a rate increase from the city of El Paso, a request the city subsequently denied. On April 21, 1998, the city council of El Paso voted to reduce the Company's rates by \$1,570,000 annually and to order a one-time cost of gas refund of \$475,000. The Company has appealed both of the council's actions to the Railroad Commission of Texas and expects a decision by the end of calendar year 1998.

On January 22, 1997, MGE was notified by the MPSC of its decision to grant an \$8,847,000 annual increase to revenue effective on February 1, 1997. Pursuant to a 1989 MPSC order, MGE is engaged in a major gas safety program in its service area (Missouri Safety Program). In connection with this program, the MPSC issued an accounting authority order (AAO) in Case No. GO-92-234 in 1994 which authorized MGE to defer depreciation expenses, property taxes and carrying costs at a rate of 10.54% on the costs incurred in the Missouri Safety Program. This AAO was consistent with those which were issued by the MPSC from 1990 to 1993 to MGE's prior owner. The MPSC rate order of January 22, 1997, however, retroactively reduced the carrying cost rate applied by the Company on the expenditures incurred on the Missouri Safety Program since early 1994 to an Allowance for Funds Used During Construction (AFUDC) rate of approximately 6%. The Company filed an appeal of that portion of the rate order in the Missouri State Court of Appeals, Western District. On August 18, 1998, the Missouri State Court of Appeals denied the Company's appeal resulting in a one-time non-cash write-off of \$5,942,000 of previously recorded deferred costs which was recorded as of June 30, 1998. The Company believes that the inconsistent treatment by the MPSC in subsequently changing to the AFUDC rate from the previously ordered 10.54% rate constitutes retroactive ratemaking. Unfortunately, the decision by the Missouri State Court of Appeals failed to address certain specific language within the 1994 AAO that the Company believed prevented the MPSC from retroactively changing the carrying cost rate. Southern Union will seek a transfer of the case to the Missouri Supreme Court; however, the likelihood of transfer is uncertain. See *MD&A -- Cautionary Statement Regarding Forward-Looking Information and Commitments and Contingencies* in the Notes to the Consolidated Financial Statements.

On September 18, 1997, the MPSC approved a global settlement among the Company, the Missouri Office of Public Counsel (OPC) and MPSC staff to resolve complaints brought by the OPC and the MPSC staff regarding billing errors

during the 1995/1996 and 1996/1997 winter heating seasons. The settlement called for credits to gas bills by MGE totaling \$1,575,000 to those customers overbilled and a \$550,000 contribution by MGE to a social service organization for the express purpose of assisting needy MGE customers in paying their gas bills. These balances were recorded as of June 30, 1997.

The approval of the January 31, 1994 acquisition of the Missouri properties by the MPSC was subject to the terms of a stipulation and settlement agreement which, among other things, requires MGE to reduce rate base by \$30,000,000 (amortized over a ten-year period on a straight-line basis) to compensate rate payers for rate base reductions that were eliminated as a result of the acquisition.

During the three-year period ended June 30, 1998, the Company did not file for any other rate increases in any of its major service areas, although several annual cost of service adjustments were filed. In addition to the regulation of its utility and pipeline businesses, the Company is affected by numerous other regulatory controls, including, among others, pipeline safety requirements of the United States Department of Transportation, safety regulations under the Occupational Safety and Health Act, and various state and federal environmental statutes and regulations. The Company believes that its operations are in compliance with applicable safety and environmental statutes and regulations.

Environmental

The Company assumed responsibility for certain environmental matters in connection with the acquisition of MGE. Additionally, the Company is investigating the possibility that the Company or predecessor companies may have been associated with manufactured gas plant sites in other of its former service territories, principally in Arizona and New Mexico, and present service territories in Texas. See *MD&A -- Cautionary Statement Regarding Forward-Looking Information and Commitments and Contingencies* in the Notes to the Consolidated Financial Statements.

Investments in Real Estate

Lavaca Realty owns a commercially developed tract of land in the central business district of Austin, Texas, containing a combined 11-story office building, parking garage and drive-through bank (Lavaca Plaza). Approximately 52% of the office space at Lavaca Plaza is used in the Company's business while the remainder is leased to non-affiliated entities. Lavaca Realty also owns a two-story office building in El Paso, Texas as well as a one-story office building in Harlingen, Texas. Other significant real estate investments held at June 30, 1998 include 39,341 square feet of undeveloped land in McAllen, Texas and 25,000 square feet of improved property in Kansas City, Missouri, of which 40% is occupied by MGE and the remainder by a non-affiliated entity.

Employees

As of August 31, 1998, the Company has 1,586 employees, of whom 1,230 are paid on an hourly basis, 337 are paid on a salary basis and 19 are paid on a commission basis. Of the 1,230 hourly paid employees, 49% are represented by unions. Of those employees represented by unions, 95% are employed by Missouri Gas Energy. On May 1, 1996, the Company agreed to three-year contracts with the bargaining-unit Missouri employees.

On June 4, 1997, Southern Union Gas employees in Austin, Texas covered by a collective bargaining agreement voted to decertify their representing union. Additionally, effective July 1, 1998, employees in Galveston, Texas chose to withdraw their membership from their representing union.

From time to time the Company may be subject to labor disputes; however, such disputes have not previously disrupted its business. The Company believes that its relations with its employees are good.

Statistics of Principal Utility and Related Operations

Southern Union Gas. The following table shows certain operating statistics of the Company's gas distribution and transportation division with operations principally in Texas:

	Year Ended June 30,		
	1998	1997	1996
Average number of gas sales customers served (a):			
Residential	465,844	456,972	457,187
Commercial	29,828	29,030	29,873
Industrial and irrigation	252	274	346
Public authorities and other	<u>2,755</u>	<u>2,673</u>	<u>2,812</u>
Total average customers served	<u>498,679</u>	<u>488,949</u>	<u>490,218</u>
Gas sales in millions of cubic feet (MMcf):			
Residential	23,217	23,135	22,945
Commercial	9,425	9,759	9,990
Industrial and irrigation	1,208	1,562	1,992
Public authorities and other	<u>2,752</u>	<u>2,756</u>	<u>2,708</u>
Gas sales billed	36,602	37,212	37,635
Net change in unbilled gas sales	<u>(82)</u>	<u>(70)</u>	<u>(5)</u>
Total gas sales	<u>36,520</u>	<u>37,142</u>	<u>37,630</u>
Gas sales revenues (thousands of dollars):			
Residential	\$ 139,856	\$ 152,737	\$ 127,255
Commercial	45,774	51,392	42,353
Industrial and irrigation	4,639	6,122	6,315
Public authorities and other	<u>11,282</u>	<u>12,975</u>	<u>9,338</u>
Gas revenues billed	201,551	223,226	185,261
Net change in unbilled gas sales revenues	<u>(492)</u>	<u>(150)</u>	<u>856</u>
Total gas sales revenues	<u>\$201,059</u>	<u>\$223,076</u>	<u>\$186,117</u>
Gas sales margin (thousands of dollars) (b):	<u>\$ 84,599</u>	<u>\$ 84,024</u>	<u>\$ 85,714</u>
Gas sales revenue per Mcf billed (c):			
Residential	\$ 6.024	\$ 6.602	\$ 5.546
Commercial	4.857	5.266	4.240
Industrial and irrigation	3.841	3.920	3.170
Public authorities and other	4.101	4.708	3.448
Weather:			
- Degree days (d)	2,118	1,962	1,901
Percent of 30-year measure (e)	99%	92%	88%
Gas transported in MMcf	16,535	15,118	16,819
Gas transportation revenues (thousands of dollars)	\$ 9,101	\$ 8,474	\$ 8,260

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- (a) Variances in the average number of customers served is primarily due to the divestiture of the Texas and Oklahoma Panhandle distribution operations in May 1996 involving 7,000 customers.
- (b) Gas sales margin is equal to gas sales revenues less purchased gas costs and revenue-related taxes.
- (c) Fluctuations in gas price billed between each period reflect changes in the average cost of purchased gas and the effect of rate adjustments.
- (d) "Degree days" are a measure of the coldness of the weather experienced. A degree day is equivalent to each degree that the daily mean temperature for a day falls below 65 degrees Fahrenheit.
- (e) Information with respect to weather conditions is provided by the National Oceanic and Atmospheric Administration. Percentages of 30-year measure are computed based on the weighted average volumes of gas sales billed. Changes in percent of 30-year measure do not necessarily impact gas sales margin since certain franchises are weather normalized.
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Missouri Gas Energy. The following table shows certain operating statistics of the Company's gas distribution and transportation division with operations in Missouri:

	<u>Year Ended June 30.</u>		
	<u>1998</u>	<u>1997</u>	<u>1996</u>
Average number of gas sales customers served:			
Residential	413,703	407,505	405,782
Commercial	57,693	56,967	56,448
Industrial	<u>312</u>	<u>312</u>	<u>321</u>
Total average customers served	<u>471,708</u>	<u>464,784</u>	<u>462,551</u>
Gas sales in MMcf:			
Residential	41,104	45,074	46,775
Commercial	18,705	20,893	21,578
Industrial	<u>400</u>	<u>490</u>	<u>592</u>
Gas sales billed	60,209	66,457	68,945
Net change in unbilled gas sales	<u>35</u>	<u>(88)</u>	<u>31</u>
Total gas sales	<u>60,244</u>	<u>66,369</u>	<u>68,976</u>
Gas sales revenues (thousands of dollars):			
Residential	\$ 267,154	\$ 284,803	\$ 259,401
Commercial	112,867	123,684	111,840
Industrial	<u>3,109</u>	<u>3,539</u>	<u>4,294</u>
Gas sales revenues billed	383,130	412,026	375,535
Net change in unbilled gas sales revenues	<u>1,660</u>	<u>(1,745)</u>	<u>2,090</u>
Total gas sales revenues	<u>\$ 384,790</u>	<u>\$ 410,281</u>	<u>\$ 377,625</u>
Gas sales margin (thousands of dollars) (a)	<u>\$ 107,394</u>	<u>\$ 106,326</u>	<u>\$ 105,945</u>
Gas sales revenue per Mcf billed:(b)			
Residential	\$ 6.499	\$ 6.319	\$ 5.546
Commercial	6.034	5.920	5.183
Industrial	7.773	7.222	7.253
Weather:			
Degree days (c)	4,723	5,506	5,495
Percent of 30-year measure: (d)	90%	105%	105%
Gas transported in MMcf	30,165	29,638	30,269
Gas transportation revenues (thousands of dollars)	\$ 9,866	\$ 11,970	\$ 10,299

(a) Gas sales margin is equal to gas sales revenues less purchased gas costs and revenue-related taxes.

(b) Fluctuations in gas price billed between each period reflect changes in the average cost of purchased gas and the effect of rate adjustments.

(c) "Degree days" are a measure of the coldness of the weather experienced. A degree day is equivalent to each degree that the daily mean temperature for a day falls below 65 degrees Fahrenheit.

(d) Information with respect to weather conditions is provided by the National Oceanic and Atmospheric Administration. Percentages of 30-year measure are computed based on the weighted average volumes of gas sales billed. Changes in percent of 30-year measure do not necessarily impact gas sales margin as a result of revenue increases approved by the MPSC.

Customers. The following table shows the number of customers served by the Company, through its divisions, subsidiaries and affiliates, as of the end of its last three fiscal years.

	<u>Gas Utility Customers as of June 30,</u>		
	<u>1998</u>	<u>1997</u>	<u>1996</u>
Southern Union Gas:			
Austin and South Texas	173,228	163,938	159,129
El Paso and West Texas	178,812	173,825	169,861
Galveston and Port Arthur	50,673	50,856	51,392
Panhandle and North Texas	24,900	24,903	24,777
Rio Grande Valley and Eagle Pass	<u>76,840</u>	<u>76,704</u>	<u>76,707</u>
	<u>504,453</u>	<u>490,226</u>	<u>481,866</u>
Missouri Gas Energy:			
Kansas City, Missouri Metropolitan Area	348,543	346,060	340,248
St. Joseph, Joplin, Monett and others	<u>121,766</u>	<u>122,946</u>	<u>119,878</u>
	<u>470,309</u>	<u>469,006</u>	<u>460,126</u>
Other (a)	<u>20,874</u>	<u>3,647</u>	<u>--</u>
Total	<u>995,636</u>	<u>962,879</u>	<u>941,992</u>

(a) Includes Mercado, South Florida Natural Gas, Atlantic Gas Corporation, SUPro and 42% (the Company's equity ownership) of the customers of a natural gas distribution company serving Piedras Negras, Mexico, in each case for the year-end in which the Company had such operations or investments.

ITEM 2. Properties.

See Item 1, *Business*, for information concerning the general location and characteristics of the important physical properties and assets of the Company.

Southern Union Gas has 7,462 miles of mains, 3,219 miles of service lines and 218 miles of transmission lines. Southern and Norteño have 171 miles and 7 miles, respectively, of transmission lines. MGE has 7,404 miles of mains, 2,709 miles of service lines and 47 miles of transmission lines. SFNG has 131 miles of mains and 78 miles of service lines. The Company considers its systems to be in good condition and well-maintained, and it has continuing replacement programs based on historical performance and system surveillance.

ITEM 3. Legal Proceedings.

See *Commitments and Contingencies* in the Notes to Consolidated Financial Statements for a discussion of the Company's legal proceedings. See *MD&A -- Cautionary Statement Regarding Forward-Looking Information*.

ITEM 4. Submission of Matters to a Vote of Security Holders.

There were no matters submitted to a vote of security holders of Southern Union during the quarter ended June 30, 1998.

PART II

ITEM 5. Market for the Registrant's Common Stock and Related Stockholder Matters.

Market Information

Southern Union's common stock is traded on the New York Stock Exchange under the symbol "SUG". The high and low sales prices (adjusted for any stock dividends and stock splits) for shares of Southern Union common stock since July 1, 1996 are set forth below:

	<u>\$/Share</u>	
	<u>High</u>	<u>Low</u>
July 1 to September 14, 1998	\$ 22.38	\$ 15.63
(Quarter Ended)		
June 30, 1998	21.75	15.92
March 31, 1998	16.50	15.25
December 31, 1997	17.20	14.44
September 30, 1997	15.56	13.81
(Quarter Ended)		
June 30, 1997	16.03	13.97
March 31, 1997	15.47	13.48
December 31, 1996	15.80	13.33
September 30, 1996	16.78	12.17

Holder

As of September 14, 1998, there were 860 holders of record of Southern Union's common stock. This number does not include persons whose shares are held of record by a bank, brokerage house or clearing agency, but does include any such bank, brokerage house or clearing agency that is a holder of record.

There were 22,210,385 shares of Southern Union's common stock outstanding on September 14, 1998 of which 16,069,564 shares were held by non-affiliates (i.e., not beneficially held by directors, executive officers, their immediate family members, or holders of 10% or more of shares outstanding).

Dividends

Southern Union's policy is to pay an annual stock dividend of approximately 5% and, therefore, the Company paid no cash dividends on its common stock during the two years ended June 30, 1998. Provisions in certain of Southern Union's long-term notes and its bank credit facilities limit the payment of cash or asset dividends on capital stock. Under the most restrictive provisions in effect, Southern Union may not declare or pay any cash or asset dividends on its common stock or acquire or retire any of Southern Union's common stock, unless no event of default exists and the Company meets certain financial ratio requirements, which presently are met.

On December 10, 1997 and December 10, 1996, the Company distributed its annual 5% common stock dividend to stockholders of record on November 21, 1997 and November 22, 1996, respectively. The 5% stock dividends are consistent with Southern Union's Board of Directors' February 1994 decision to commence regular stock dividends of approximately 5% annually. The specific amount and declaration, record and distribution dates for an annual stock dividend will be determined by the Board and announced at a date that is not expected to be later than the annual stockholders meeting each year. The next annual stock dividend is expected to be declared in connection with the Company's annual meeting of stockholders to be held on November 12, 1998.

On July 13, 1998, Southern Union effected a 3-for-2 stock split by distributing a 50% stock dividend to holders of record on June 30, 1998.

ITEM 6. Selected Financial Data.

	Year Ended June 30.				
	1998(a)(b)	1997(a)	1996(a)	1995	1994(c)
	(dollars in thousands, except per share amounts)				
Total operating revenues	\$ 669,304	\$ 717,031	\$ 620,391	\$ 479,983	\$ 372,043
Earnings from continuing operations (d) ..	12,229	19,032	20,839	16,069	8,378
Earnings per common and common share equivalents (e)43	.68	.76	.59	.36
Total assets	1,047,764	990,403	964,460	992,597	887,807
Common stockholders' equity	296,834	267,462	245,915	225,664	208,975
Short-term debt and capital lease obligation	1,777	687	615	770	889
Long-term debt and capital lease obligation, excluding current portion	406,407	386,157	385,394	462,503	479,048
Company-obligated mandatorily redeemable preferred securities of subsidiary trust	100,000	100,000	100,000	100,000	--
Average customers served	979,186	955,838	952,934	947,691	653,102

- (a) Certain Texas and Oklahoma Panhandle distribution operations and Western Gas Interstate, exclusive of the Del Norte interconnect, were sold on May 1, 1996.
- (b) On December 31, 1997, Southern Union acquired Atlantic for 755,650 pre-split shares of common stock valued at \$18,041,000 and cash of \$4,436,000.
- (c) Missouri Gas Energy, a division of Southern Union, was acquired on January 31, 1994 and was accounted for as a purchase. Missouri Gas Energy's assets were included in the Company's consolidated balance sheet at January 31, 1994 and its results of operations were included in the Company's consolidated results of operations beginning February 1, 1994. For these reasons, the consolidated results of operations of the Company for the periods subsequent to the acquisition are not comparable.
- (d) As of June 30, 1998, MGE wrote off \$8,163,000 pre-tax in previously recorded regulatory assets as a result of announced rate orders and court rulings.
- (e) Earnings per share for all periods presented were computed based on the weighted average number of shares of common stock and common stock equivalents outstanding during the year adjusted for (i) the 5% stock dividends distributed on December 10, 1997, December 10, 1996, November 27, 1995 and June 30, 1994, and (ii) the 50% stock dividend distributed on July 13, 1998, the 33 1/3% stock dividend distributed on March 11, 1996 and the 50% stock dividend distributed on March 9, 1994.

ITEM 7. Management's Discussion and Analysis of Results of Operations and Financial Condition.

Overview Southern Union Company's principal business is the distribution of natural gas as a public utility through three divisions: Southern Union Gas, Missouri Gas Energy (MGE) and Atlantic Utilities doing business as South Florida Natural Gas (SFNG). Southern Union Gas serves 511,000 customers in Texas (including the cities of Austin, Brownsville, El Paso, Galveston, Harlingen, McAllen and Port Arthur), and MGE serves 482,000 customers in central and western Missouri (including the cities of Kansas City, St. Joseph, Joplin and Monett). SFNG, acquired as of December 31, 1997, serves portions of central Florida (including New Smyrna Beach, Edgewater and areas of Volusia County, Florida). SFNG's results of operations since its acquisition do not materially impact comparability between fiscal years discussed below.

The Company also operates natural gas pipeline systems, markets natural gas to end-users, distributes propane and holds investments in real estate and other assets. To achieve profitability and continued growth, the Company continues to emphasize gas sales in nontraditional markets, operating efficiencies of existing systems, and expansion through selective acquisitions of new systems.

Results of Operations

Net Earnings Southern Union Company's 1998 (fiscal year ended June 30) net earnings were \$12,229,000 (\$.43 per common share, diluted for outstanding options and warrants -- hereafter referred to as *per share*), compared with \$19,032,000 (\$.68 per share) in 1997. The decrease was primarily due to the pre-tax write-off of previously recorded regulatory assets as ordered by the Missouri Public Service Commission (MPSC). On August 18, 1998, the Missouri Court of Appeals denied the previously disclosed appeal by the Company of the MPSC's January 1997 Rate Order granted to MGE. Because of this decision, the Company recorded a one-time non-cash write-off of \$5,942,000 of deferred costs recorded since 1994. On August 21, 1998, the MPSC also granted MGE a rate increase which, among other things, disallowed certain previously recorded deferred costs requiring an additional pre-tax non-cash write-off of \$2,221,000. Significantly warmer weather in the winter of 1997/1998, especially in Missouri, also contributed to the decrease in earnings, despite an \$8,847,000 annual increase to MGE revenues granted by the MPSC effective February 1, 1997. Weather in the Missouri service territories during 1998 was 14% warmer than 1997 while gas sales volumes in the corresponding period decreased 9%. Average common and common share equivalents outstanding increased 2.5% in 1998 due to the issuance of 755,650 pre-split shares of the Company's common stock on December 31, 1997 in connection with the acquisition of Atlantic Utilities Corporation and Subsidiaries in Florida. The Company earned 4.3% on average common equity in 1998.

The Company's 1997 net earnings were \$19,032,000 (\$.68 per share), compared with \$20,839,000 (\$.76 per share) in 1996. The decrease was primarily due to \$5,763,000 in additional bad debt expense in 1997 as a result of significant increases in delinquent customer accounts, principally at MGE. The significant increase in natural gas prices during 1997 caused many customers to receive considerably higher heating bills. Additionally, certain billing errors were discovered in MGE's billing practices and procedures. As a result of the customer's increased bills and negative media coverage over the high gas costs and billing errors, more customers than usual failed to pay their bills causing an unanticipated increase in aged receivables, primarily in Missouri. MGE also responded to an MPSC directive to delay collection efforts by suspending the disconnection of customers for non-payment until July 1997. Also adversely impacting 1997 net earnings was \$2,125,000 in various settlement fees in connection with complaints brought by the Missouri Office of Public Counsel and the MPSC for the billing errors. Contributing to 1997 net earnings were additional revenues of \$4,600,000 under a gas supply incentive plan approved by the MPSC in July 1996. Under the plan, Southern Union and its Missouri customers shared in certain savings below benchmark levels of gas costs incurred as a result of the Company's gas procurement activities. The incentive plan achieved a reduction of overall gas costs of \$10,200,000, resulting in savings to Missouri customers of \$5,600,000. Average common and common share equivalents outstanding increased 1.1% in 1997. The Company earned 7.4% and 8.8% on average common equity in 1997 and 1996, respectively.

Operating Revenues Operating revenues in 1998 decreased \$47,727,000, or 7%, to \$669,304,000, while gas purchase costs decreased \$43,608,000, or 10%, to \$405,580,000.

Operating revenues and gas purchase costs in 1998 were affected by both a reduction in gas sales volumes and decreases in the cost of gas. Gas sales volumes decreased 6% in 1998 to 115,261 MMcf due to the warmer winter weather in the Missouri service territories. Gas sales volumes were also impacted by a reduction in average usage per customer throughout the Company's service territories as a result of more energy efficient housing and appliances. The average cost of gas decreased \$.18 to \$3.49 per Mcf in 1998 due to decreases in average spot market gas prices

throughout the Company's distribution system as a result of seasonal impacts on demands for natural gas and the ensuing competitive pricing within the industry. The average spot market price of natural gas decreased 3% to \$2.24 per million British thermal units (MMBtu) in 1998. Additionally impacting operating revenues in 1998 was a \$4,616,000 decrease in gross receipt taxes, a \$2,104,000 decrease in gas transportation revenues at MGE, and decreased revenues of \$500,000 under the previously discussed gas supply incentive plan. Gross receipt taxes are levied on sales revenues, then collected from the customers and remitted to the various taxing authorities. Operating revenues were favorably impacted by an \$8,847,000 annual increase to revenues granted by the MPSC effective as of February 1, 1997.

Southern Union Gas and MGE contributed 32% and 59%, respectively, of the Company's consolidated 1998 operating revenues. Four suppliers provided 45% of gas purchases in 1998.

Gas purchase costs generally do not directly affect earnings since these costs are generally passed on to customers pursuant to purchase gas adjustment clauses. Accordingly, while changes in the cost of gas may cause the Company's operating revenues to fluctuate, net operating margin is generally not affected by increases or decreases in the cost of gas. Increases in gas purchase costs indirectly affect earnings as the customer's bill increases, usually resulting in increased bad debt and collection costs being recorded by the Company.

Gas transportation volumes in 1998 decreased 3,380 MMcf to 59,153 MMcf at an average transportation rate per Mcf of \$.33 compared with \$.34 in 1997. Transportation volumes increased from 29,638 MMcf to 30,165 MMcf in 1998 for MGE and decreased from 32,895 MMcf to 28,988 MMcf in 1998 for Southern Union Gas and the Company's pipeline subsidiaries. This decrease was mainly caused by a 32% decrease, or 5,531 MMcf, in the amount of volumes transported into Mexico by Norteño Pipeline Company, a subsidiary of the Company.

Operating revenues in 1997 increased \$96,640,000, or 16%, to \$717,031,000 while gas purchase costs increased \$87,649,000, or 24%, to \$449,188,000.

Operating revenues and gas purchase costs in 1997 were affected by an increase in the average cost of gas and greater gas sales volumes. The average cost of gas increased \$.62 to \$3.67 per Mcf in 1997 due to increases in spot market gas prices as a result of the increased demand for natural gas during the 1996/1997 winter season. The average spot market price of natural gas increased 38% to \$2.32 per MMBtu, in 1997. Gas sales volumes increased 3% in 1997 to 121,996 MMcf due to growth in pipeline and marketing sales which typically have lower margins. This was partially offset by a reduction in volumes of 878 MMcf from the sale of certain operations in the Texas and Oklahoma Panhandles on May 1, 1996. Additionally impacting operating revenues was the \$8,847,000 annual increase to revenues granted by the MPSC effective as of February 1, 1997, and increased revenues under the gas supply incentive plan, previously discussed. Also contributing to the increase in operating revenues was a \$4,616,000 increase in gross receipt taxes.

Southern Union Gas and MGE contributed 33% and 60%, respectively, of the Company's consolidated 1997 operating revenues. Four suppliers provided 44% of gas purchases in 1997.

Gas transportation volumes in 1997 increased 358 MMcf to 62,533 MMcf at an average transportation rate per Mcf of \$.34 compared with \$.31 in 1996. Transportation volumes decreased from 30,269 MMcf to 29,638 MMcf in 1997 for MGE and increased 3% in 1997 for Southern Union Gas and the Company's pipeline subsidiaries. This was partially offset by a reduction in volumes of 2,452 MMcf from the sale of certain operations, previously discussed.

Net Operating Margin Net operating margin in 1998 (operating revenues less gas purchase costs and revenue-related taxes) increased by \$497,000, compared with an increase of \$4,375,000, in 1997. Operating margins and earnings are primarily dependent upon gas sales volumes and gas service rates. The level of gas sales volumes is sensitive to the variability of the weather. Southern Union Gas and MGE accounted for 43% and 52%, respectively, of the Company's net operating margin in 1998 and 42% and 55%, respectively, in 1997.

Weather Weather in the Missouri service territories in 1998 was 90% of a 30-year measure, 14% warmer than in 1997. Weather in 1998 in Southern Union Gas service territories was 99% of a 30-year measure, 8% colder than in 1997. Weather in Missouri in both 1997 and 1996 was 105% of the 30-year measure, while weather in the Southern Union Gas service territories in 1997 was 92% of the 30-year measure, 5% colder than in 1996.

Customers The average number of customers served in 1998, 1997 and 1996 was 979,186, 955,838 and 952,934, respectively. These customer totals do not include Southern Union's 42% equity ownership acquired on July 23, 1997

in a natural gas distribution company in Piedras Negras, Mexico which currently serves 17,500 customers. Southern Union Gas served 498,679 residential, commercial, industrial, agricultural and other gas utility customers in the State of Texas during 1998. The 1997 gas utility customer base in Texas decreased slightly due to the divestiture of certain Texas and Oklahoma Panhandle distribution operations in May 1996 involving 7,000 customers. MGE served 471,708 customers in central and western Missouri during 1998. SFNG and Atlantic Gas Corporation, a propane subsidiary of the Company, served 4,158 and 805 customers, respectively, since being acquired on December 31, 1997. SUPro Energy Company (SUPro), a subsidiary of the Company, served 8,527 propane customers in Texas during 1998.

Operating Expenses Operating, maintenance and general expenses in 1998 decreased \$2,361,000, or 2%, to \$107,527,000. Included in this decrease was \$5,837,000 less in bad debt expense due to a significant increase in delinquent customer accounts in 1997, previously discussed. Partially offsetting this factor was an increase in reserves for litigation claims and settlements.

Depreciation and amortization expense in 1998 increased \$3,610,000 to \$38,439,000 as a result of including certain costs into rate base that were previously deferred as provided in the MGE revenue increase effective as of February 1, 1997 and normal growth in plant. Taxes other than on income and revenues, principally consisting of property, payroll and state franchise taxes, in 1998 increased \$2,051,000 to \$14,205,000. The increase was primarily due to increases in property taxes resulting from the inclusion of certain plant assets pursuant to the MGE Safety Program that were deferred prior to the February 1, 1997 revenue increase in Missouri.

Operating, maintenance and general expenses in 1997 increased \$2,367,000, or 2%, to \$109,888,000. Included in this increase was \$5,763,000 in additional bad debt expense due to significant increases in delinquent customer accounts principally at MGE, previously discussed; increased media advertising; travel and call center labor costs as a result of and in response to the significant price spikes in natural gas during the 1996/1997 winter heating season; and increased field and call center labor and other costs to improve customer service at MGE. Partially offsetting these factors was a decrease in medical, dental, pension and injury and damage claims.

Depreciation and amortization expense in 1997 increased \$1,847,000 to \$34,829,000 as a result of including certain costs into rate base that were previously deferred as provided in the MGE revenue increase case effective as of February 1, 1997 and normal growth in plant. Taxes other than on income and revenues, in 1997 decreased \$1,505,000 to \$12,154,000. The decrease was primarily due to decreases in assessed property tax values in several Texas taxing jurisdictions, a decrease in Missouri state franchise tax and a reduction in payroll taxes from the decrease in employees.

Employees The Company employed 1,594, 1,595 and 1,611 individuals as of June 30, 1998, 1997, and 1996, respectively. After gas purchases and taxes, employee costs and related benefits are the Company's most significant expense. Such expense includes salaries, payroll and related taxes and employee benefits such as health, savings, retirement and educational assistance. On May 1, 1996, the Company agreed to three-year contracts with each of the four unions that represent the bargaining-unit employees of MGE.

Interest Expense and Dividends on Preferred Securities Total interest expense in 1998 increased by \$1,419,000, or 4%, to \$34,884,000. Interest expense on long-term debt and capital leases increased by \$577,000 in 1998 primarily due to MGE's capital lease obligation of \$22,151,000 incurred in 1998 for the installation of an Automated Meter Reading (AMR) system.

Interest expense on short-term debt in 1998 increased \$566,000 to \$2,399,000, due to the average short-term debt outstanding during 1998 increasing \$9,333,000 to \$39,105,000. The average rate of interest on short-term debt was 6.1% in both 1998 and 1997.

Total interest expense in 1997 declined by \$2,367,000, or 7%, to \$33,465,000. Interest expense on long-term debt decreased by \$4,205,000 in 1997 primarily due to the timing of the repurchase of \$90,485,000 of the Senior Notes at various dates from June 1995 to June 1996. The funds used for the various repurchases of debt were obtained, in part, from the May 17, 1995 issuance of the Preferred Securities and working capital.

Interest expense on short-term debt in 1997 increased \$1,629,000 to \$1,833,000, due to the average short-term debt outstanding during 1997 increasing \$27,093,000 to \$29,772,000. The average short-term debt balance outstanding during 1996 of \$2,679,000 was the result of the available cash balance on hand from the sale of the Preferred Securities. The average rate of interest on short-term debt was 6.1% in 1997 compared with 7.4% in 1996.

Write-Off of Regulatory Assets During 1998, the Company was impacted by pre-tax non-cash write-offs totaling \$8,163,000 of previously recorded regulatory assets. Pursuant to a 1989 MPSC order, MGE is engaged in a major gas safety program. In connection with this program, the MPSC issued an accounting authority order in 1994 which authorized MGE to defer carrying costs at a rate of 10.54%. The MPSC rate order of January 22, 1997, however, retroactively reduced the 10.54% carrying cost rate used since early 1994 to an Allowance for Funds Used During Construction (AFUDC) rate of approximately 6%. The Company filed an appeal of this portion of the rate order in the Missouri State Court of Appeals, Western District, and on August 18, 1998 was notified that the appeal was denied. This resulted in a one-time non-cash write-off of \$5,942,000 of previously deferred costs as of June 30, 1998. See *Commitments and Contingencies* in the Notes to Consolidated Financial Statements.

On August 21, 1998, MGE was notified by the MPSC of its decision to grant a \$13,300,000 annual increase to revenue effective on September 2, 1998. The MPSC Rate Order reflected a 10.93% return on common equity. The Rate Order, however, disallowed certain previously recorded deferred costs associated with the rate filing, requiring a non-cash write-off of \$2,221,000. Though the Company has requested a rehearing on significant portions of these disallowances, generally accepted accounting principles require the Company to immediately record this charge to earnings which Southern Union did as of June 30, 1998.

Other Income (Expense), Net Other income, net, in 1998 increased by \$1,193,000 to \$4,073,000. Other income in 1998 included \$1,671,000 in deferral of interest and other expenses associated with the MGE Safety Program; realized gains on the sale of investment securities of \$1,088,000; and net rental income of Lavaca Realty Company, (Lavaca Realty), the Company's real estate subsidiary, of \$1,119,000.

Other income in 1997 included \$3,729,000 in deferral of interest and other expenses associated with the MGE Safety Program; realized gains on the sale of investment securities of \$2,545,000; and net rental income of Lavaca Realty of \$1,329,000. This was partially offset by \$2,125,000 for the settlement of certain billing errors, previously discussed; the write-off of \$1,750,000 acquisition-related costs from the termination of various acquisition activities; and a \$257,000 expense associated with the donation of emissions analysis equipment and software to a Texas university.

Other income in 1996 included \$5,664,000 in deferral of interest and other expenses associated with the MGE Safety Program; a \$2,300,000 pre-tax gain on the sale of Western Gas Interstate Company (WGI), a former subsidiary of the Company, and other distribution operations on May 1, 1996; investment interest and interest on notes receivable of \$2,051,000; net rental income of Lavaca Realty of \$1,392,000; and gains on the repurchase of Senior Notes of \$1,581,000. This was partially offset by losses of \$470,000 on the sale of undeveloped real estate.

Federal and State Income Taxes Federal and state income tax expense in 1998, 1997, and 1996 was \$7,984,000, \$12,373,000 and \$14,979,000, respectively. The decrease in income taxes during 1998 and 1997 was due to the decrease in pre-tax income, previously discussed.

Liquidity and Capital Resources

Operating Activities The seasonal nature of Southern Union's business results in a high level of cash flow needs to finance gas purchases, outstanding customer accounts receivable and certain tax payments. To provide these funds, as well as funds for its continuing construction and maintenance programs, the Company has historically used its credit facilities along with internally-generated funds. Because of available short-term credit and the ability to obtain various market financing, management believes it has adequate financial flexibility to meet its cash needs.

Cash flow from operating activities in 1998 increased by \$20,263,000 to \$68,257,000, and decreased by \$19,471,000 to \$47,994,000 in 1997. Operating activities were impacted by a reduction in net earnings in 1998 and 1997, the non-cash write-off of previously recorded regulatory assets in 1998 discussed above, increased accounts receivable balances in 1997 due to increases in delinquent customer accounts discussed above and general changes in other operating accounts. The previously-mentioned August 21, 1998 MPSC Rate Order is anticipated to increase the Company's after-tax cash flow by approximately \$8,000,000 annually.

At June 30, 1998, 1997 and 1996, the Company's primary sources of liquidity included borrowings available under the Company's credit facilities and cash and cash equivalents of nil, nil and \$2,887,000, respectively. A balance of \$1,600,000 was outstanding under the credit facilities at both June 30, 1998 and 1997. A balance of \$7,400,000 was outstanding under the facilities at July 31, 1998.

Investing Activities Cash flow used in investing activities in 1998 increased by \$11,619,000 to \$65,634,000, and increased by \$22,556,000 to \$54,015,000 in 1997. Investing activity cash flow was primarily affected by additions to property, plant and equipment, acquisition of operations, sales and purchases of investment securities and the sale of various properties.

During 1998, 1997 and 1996, the Company expended \$77,018,000, \$64,463,000 and \$59,376,000, respectively, for capital expenditures excluding acquisitions. These expenditures primarily related to distribution system replacement and expansion. Included in these capital expenditures were \$21,125,000, \$20,972,000 and \$19,761,000 for the MGE Safety Program in 1998, 1997 and 1996, respectively. Cash flow from operations has historically been utilized to finance capital expenditures and is expected to be the primary source for future capital expenditures.

On December 31, 1997, Southern Union acquired Atlantic Utilities Corporation and Subsidiaries (Atlantic) for 755,650 pre-split shares of common stock and cash of \$4,436,000. On the date of acquisition, Atlantic had \$11,683,000 of cash and cash equivalents.

During 1998, the Company purchased investment securities of \$5,000,000 and had proceeds from the sale of investment securities of \$6,531,000. During 1997, the Company purchased investment securities of \$5,363,000 and had proceeds from the sale of investment securities of \$13,327,000. During 1996, the Company purchased \$10,763,000 in investment securities. As of June 30, 1998, the investment securities are accounted for under the cost method.

On May 1, 1996, the Company consummated the sale of various operations for \$15,900,000. The operations included certain gas distribution operations of the Company in the Texas and Oklahoma Panhandles and WGI, exclusive of the Del Norte interconnect which transports natural gas into Mexico.

The Company began installing an AMR system at MGE in 1998 which was substantially completed in the first quarter of fiscal year 1999. The installation of the AMR system involved an investment of \$30,550,000 which is accounted for as a capital lease obligation. During 1998, the Company recorded an increase in plant, long-term debt and other liabilities of \$26,464,000. This system will improve meter reading accuracy and provide electronic accessibility to meters in residential customers' basements, thereby assisting in the reduction of the number of estimated bills.

Financing Activities Cash flow used in financing activities in 1998 was \$2,623,000, while cash flow from financing activities was \$3,134,000 in 1997. Cash flow used in financing activities in 1996 was \$72,134,000. Financing activity cash flow changes were primarily due to repayment of debt and the various financing transactions during the past three years. As a result of these financing transactions, the Company's total debt to total capital ratio at June 30, 1998 was 50.6%, compared with 51.2% and 52.7% at June 30, 1997 and 1996, respectively. The Company's effective debt cost rate under the current debt structure is 7.8% (which includes interest and the amortization of debt issuance costs and redemption premiums on refinanced debt).

On May 17, 1995, Southern Union Financing I (Subsidiary Trust), a consolidated wholly-owned subsidiary of Southern Union, issued \$100,000,000 of Preferred Securities. The issuance of the Preferred Securities was part of a \$300,000,000 shelf registration filed with the Securities and Exchange Commission on March 29, 1995. Southern Union may sell a combination of preferred securities of financing trusts and senior and subordinated debt securities of Southern Union of up to \$196,907,200 (the remaining shelf) from time to time, at prices determined at the time of any offering. The net proceeds from the Preferred Securities offering, along with working capital from operations, were used to repurchase \$90,485,000 of the Senior Notes through June 1996 with the remaining balance used to provide working capital for seasonal needs. Depending upon market conditions and available cash balances, the Company may repurchase additional Senior Notes in the future. See *Preferred Securities of Subsidiary Trust and Debt and Capital Lease* in the Notes to the Consolidated Financial Statements.

Southern Union has availability under a \$100,000,000 revolving credit facility (Revolving Credit Facility) underwritten by a syndicate of banks. The Company has additional availability under uncommitted line of credit facilities (Uncommitted Facilities) with various banks. Covenants under the Revolving Credit Facility allow for up to \$35,000,000 of borrowings under Uncommitted Facilities at any one time. Borrowings under these facilities are available for Southern Union's working capital, letter of credit requirements and other general corporate purposes. The facilities are uncollateralized and have no borrowing base limitations as long as the Company's Senior Notes meet certain rating criteria. The Company may use up to \$40,000,000 of the Revolving Credit Facility to finance future acquisitions. These facilities contain certain financial covenants that, among other things, restrict cash or asset dividends, share repurchases, certain investments and additional debt. The facility expires on December 31, 1999 but may be extended

annually for periods of one year with the consent of each of the banks. The Revolving Credit Facility is subject to a commitment fee based on the rating of the Company's Senior Notes. As of June 30, 1998 the commitment fee was an annualized .15% on the unused balance.

The Company had standby letters of credit outstanding of \$2,947,000 at both June 30, 1998 and 1997, which guarantee payment of various insurance premiums and state taxes.

Other Matters

Propane Operations SUPro and Atlantic Gas Corporation currently serve 8,527 and 769 customers, respectively, at June 30, 1998. These propane operations sold 5,758,000 and 2,417,000 gallons of propane during 1998 and 1997, respectively, and allow the Company to provide a greater scope of energy services.

Foreign Operations On July 23, 1997, Energia Estrella del Sur, S. A. de C. V., a wholly-owned subsidiary of Southern Union Energy International, Inc. and Southern Union International Investments, Inc., both subsidiaries of the Company, acquired a 42% equity ownership in a natural gas distribution company and other operations which currently serves 17,500 customers in Piedras Negras, Mexico, which is across the border from the Company's Eagle Pass, Texas service area. On September 8, 1997, Southern Transmission Company, another subsidiary of the Company, purchased a 45-mile intrastate pipeline for \$305,000 which will augment the Company's gas supply to the city of Eagle Pass and, subject to necessary regulatory approvals, ultimately Piedras Negras. Financial results of these foreign operations did not have a significant impact on the Company's financial results during 1998.

Stock Splits and Dividends On July 13, 1998, a three-for-two stock split was distributed in the form of a 50% stock dividend. Additionally, Southern Union distributed annual 5% common stock dividends on December 10, 1997 and December 10, 1996. Unless otherwise stated, all per share data included herein and in the accompanying Consolidated Financial Statements and Notes thereto have been restated to give effect to the stock splits and stock dividends.

Contingencies The Company assumed responsibility for certain environmental matters in connection with the acquisition of MGE. Additionally, the Company is investigating the possibility that the Company or predecessor companies may have been associated with Manufactured Gas Plant sites in other of its former service territories, principally in Arizona and New Mexico, and present service territories in Texas.

On August 18, 1998, a jury in Edinburg, Texas concluded deliberations on the City of Edinburg's franchise fee lawsuit against Valero Energy Corporation (Valero) and a number of its subsidiaries, as well as former Valero subsidiary Rio Grande Valley Gas Company (RGV) and RGV's successor company, Southern Union Company. The case, based upon events that occurred between 1985-1987, centers on specific contractual language in the 1985 franchise agreement between RGV and the City of Edinburg. Southern Union purchased RGV from Valero in October 1993. The jury awarded the plaintiff damages, under several largely overlapping but mutually exclusive claims, totaling approximately \$13,000,000. The actual amount and appropriate allocation of the surviving portions of the damage awards will not be determined until further proceedings are completed, including the trial judge's decision on post-trial motions. The Company is pursuing having the jury's verdict overturned or reduced by the trial judge, and if necessary will vigorously pursue a reversal on appeal. The Company believes it will ultimately prevail and thus has not provided for any loss relative to this matter in its financial statements. Furthermore, the Company has not determined what impact, if any, this jury decision may have on other city franchises in Texas.

On August 18, 1998, the Missouri Court of Appeals, Western District, denied the Company's appeal of the February 1, 1997 rate order which retroactively reduced the carrying cost rate applied by the Company on expenditures incurred on the MGE Safety Program. The Company believes that the inconsistent treatment by the MPSC in subsequently changing to the Allowance for Funds Used During Construction rate of approximately 6% from the previously ordered rate of 10.54% constitutes retroactive ratemaking. Unfortunately, the decision by the Missouri State Court of Appeals failed to address certain specific language within a 1994 MPSC accounting authority order that the Company believed prevented the MPSC from retroactively changing the carrying cost rate. Southern Union will seek a transfer of the case to the Missouri Supreme Court; however, the likelihood of transfer is uncertain. See *Results of Operations -- Write-Off of Regulatory Assets*.

Southern Union and its subsidiaries are parties to other legal proceedings that management considers to be normal actions to which an enterprise of its size and nature might be subject, and not to be material to the Company's overall business or financial condition, results of operations or cash flows.

See *Commitments and Contingencies* in the Notes to Consolidated Financial Statements.

Inflation The Company believes that inflation has caused and will continue to cause increases in certain operating expenses and has required and will continue to require assets to be replaced at higher costs. The Company continually reviews the adequacy of its gas rates in relation to the increasing cost of providing service and the inherent regulatory lag in adjusting those gas rates.

Regulatory The majority of the Company's business activities are subject to various regulatory authorities. The Company's financial condition and results of operations have been and will continue to be dependent upon the receipt of adequate and timely adjustments in rates. Gas service rates, which consist of a monthly fixed charge and a gas usage charge, are established by regulatory authorities and are intended to permit utilities the opportunity to recover operating, administrative and financing costs and to have the opportunity to earn a reasonable return on equity. The monthly fixed charge provides a base revenue stream while the usage charge increases the Company's revenues and earnings in colder weather when natural gas usage increases.

On September 18, 1997, the MPSC approved a global settlement among the Company, the Missouri Office of Public Counsel (OPC) and MPSC to resolve complaints brought by the OPC and the MPSC staff regarding billing errors during the 1995/1996 and 1996/1997 winter heating seasons. The settlement called for credits to gas bills by MGE totaling \$1,575,000 to those customers overbilled and a \$550,000 contribution by MGE to a social service organization for the express purpose of assisting needy MGE customers in paying their gas bills. These balances were recorded as of June 30, 1997.

In August 1997, the MPSC issued an order authorizing MGE to begin making semi-annual purchase gas adjustments (PGA) in November and April, instead of more frequent adjustments as in the past. Additionally, the order authorized MGE to establish an Experimental Price Stabilization Fund for purposes of procuring natural gas financial instruments to hedge a minimal portion of its gas purchase costs for the winter heating season. The cost of purchasing these financial instruments and any gains derived from such activities are passed on to the Missouri customers through the PGA. Accordingly, there is no earnings impact as a result of the use of these financial instruments. These procedures help stabilize the monthly heating bills for Missouri customers. The Company believes it bears minimal risk under the authorized transactions.

The MPSC also approved a three-year, experimental gas supply incentive plan for MGE effective July 1, 1996. Under the plan, the Company and MGE's customers share in certain savings below benchmark levels of gas costs achieved as a result of the Company's gas procurement activities. Likewise, if natural gas is acquired above benchmark levels, both the Company and customers share in such costs. For the year ended June 30, 1998 and 1997, the incentive plan achieved a reduction of overall gas costs of \$9,200,000 and \$10,200,000, respectively, resulting in savings to Missouri customers of \$5,100,000 and \$5,600,000, respectively. The Company recorded revenues of \$4,100,000 in 1998 and \$4,600,000 in 1997 under this plan. There can be no assurance that this or any similar plan will be approved by the MPSC for MGE after this plan expires on July 1, 1999.

On April 13, 1998, Southern Union Gas filed a \$2,228,000 request for a rate increase from the city of El Paso, a request the city subsequently denied. On April 21, 1998, the city council of El Paso voted to reduce the Company's rates by \$1,570,000 annually and to order a one-time cost of gas refund of \$475,000. The Company has appealed both of the council's actions to the Railroad Commission of Texas and expects a decision by the end of calendar year 1998.

On January 22, 1997, MGE was notified by the MPSC of its decision to grant an \$8,847,000 annual increase to revenue effective as of February 1, 1997. Southern Union Gas also received several annual cost of service adjustments in 1998, 1997 and 1996. See *Utility Regulation and Rates* and *Commitments and Contingencies* in the Notes to Consolidated Financial Statements.

Pursuant to a 1989 MPSC order, MGE is engaged in a major gas safety program in its service territories. This program includes replacement of company- and customer-owned gas service and yard lines, the movement and resetting of meters, the replacement of cast iron mains and the replacement and cathodic protection of bare steel mains. In recognition of the significant capital expenditures associated with this safety program, the MPSC permits the deferral, and subsequent recovery through rates, of depreciation expense, property taxes and associated carrying costs. The continuation of the MGE Safety Program will result in significant levels of future capital expenditures. The Company estimates incurring capital expenditures of \$19,000,000 in fiscal 1999 related to this program which are

expected to be financed through cash flow from operations. See *Utility Regulation and Rates and Commitments and Contingencies* in the Notes to Consolidated Financial Statements.

The Company is continuing to pursue certain changes to rates and rate structures that are intended to reduce the sensitivity of earnings to weather including weather normalization clauses and higher minimum monthly service charges. Southern Union Gas has weather normalization clauses in Austin, certain El Paso service area cities, Port Arthur, Galveston and in two other service areas in Texas. These clauses allow for the adjustments that help stabilize customers' monthly bills and the Company's earnings from the varying effects of weather.

Year 2000 Similar to all business entities, the Company will be impacted by the inability of computer application software programs to distinguish between the year 1900 and 2000 due to a commonly-used programming convention. Unless such programs are modified or replaced prior to 2000, calculations and interpretations based on date-based arithmetic or logical operations performed by such programs may be incorrect.

Management's plan addressing the impact of the Year 2000 issue on the Company focuses on the following areas: application systems, process control systems (embedded chips), technology infrastructure, physical infrastructure, and third party business partners and suppliers with which the Company has significant relationships. Management's analysis and review of these areas is comprised primarily of five phases: developing an inventory of hardware, software and embedded chips; assessing the degree to which each area is currently in compliance with Year 2000 requirements; performing renovations and repairs as needed to attain compliance; testing to ensure compliance; and developing a contingency plan if repair and renovation efforts are either unsuccessful or untimely.

Management has substantially completed the inventory and assessment phases regarding application systems, process control systems and technology infrastructure, and is performing renovations, repairs and testing of the former two categories. The review of physical infrastructure and business partners, gas transporters and suppliers is in the inventory stage. While the Company anticipates that any additional inventory and assessment efforts will be completed by the end of calendar year 1998, renovation, repair and testing of affected areas will continue through calendar year 1999. Costs incurred to date have primarily consisted of labor from the redeployment of existing information technology, legal and operational resources. The Company expects to spend approximately \$3 million for these Year 2000 compliance efforts. To the extent that such costs are incurred in Year 2000 compliance efforts, the Company will attempt recovery for such costs through regulatory relief.

In addition to the activities described above, the Company is currently replacing some of its financial and operating software programs with new programs that will be Year 2000 compliant. These new programs have significantly reduced the costs the Company expects to incur to become Year 2000 compliant. However, the Company has formed a contingency team to develop a work plan in the event that such programs are not fully operational by the end of calendar year 1999. The costs associated with this effort are being evaluated and cannot yet be determined. Although the Company does not presently anticipate a material business interruption as a result of the Year 2000, the worst case scenario if all of the Company's Year 2000 efforts failed, including the failure of third party providers to deliver services, could result in daily lost revenues of approximately \$3,200,000. This estimate is based on historical revenues recognized in the month of January.

Accounting Pronouncements The Financial Accounting Standards Board (FASB) recently issued *Employers' Disclosures about Pensions and Other Postretirement Benefits* which revises employers' disclosures about pension and other postretirement benefit plans. The Company is required to adopt the provisions of this standard by June 30, 1999.

The FASB also issued *Reporting Comprehensive Income and Disclosures about Segments of an Enterprise and Related Information*, which establish procedures for reporting and display of comprehensive income and its components, and certain disclosures about segment information in interim and annual financial statements and related information about products, services, geographic areas and major customers, respectively. The Company will adopt the provisions of these standards for the fiscal year ending June 30, 1999, but does not expect the adoption thereof to have a material effect on the Company's financial position, results of operations or cash flows.

See the Notes to Consolidated Financial Statements for other accounting pronouncements followed by the Company.

Cautionary Statement Regarding Forward-Looking Information This Management's Discussion and Analysis of Results of Operations and Financial Condition and other sections of this Annual Report on Form 10-K contain forward-looking statements that are based on current expectations, estimates and projections about the industry in which the

Company operates, management's beliefs and assumptions made by management. Words such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions, which are difficult to predict and many of which are outside the Company's control. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. The Company undertakes no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. Readers are cautioned not to put undue reliance on such forward-looking statements. Stockholders may review the Company's reports filed in the future with the Securities and Exchange Commission for more current descriptions of developments that could cause actual results to differ materially from such forward-looking statements.

Factors that could cause or contribute to actual results differing materially from such forward-looking statements include the following: cost of gas; gas sales volumes; weather conditions in the Company's service territories; the achievement of operating efficiencies and the purchases and implementation of new technologies for attaining such efficiencies; impact of relations with labor unions of bargaining-unit employees; the receipt of timely and adequate rate relief; the outcome of pending and future litigation; governmental regulations and proceedings affecting or involving the Company; and the nature and impact of any extraordinary transactions such as any acquisition or divestiture of a business unit or any assets. These are representative of the factors that could affect the outcome of the forward-looking statements. In addition, such statements could be affected by general industry and market conditions, and general economic conditions, including interest rate fluctuations, federal, state and local laws and regulations affecting the retail gas industry or the energy industry generally, and other factors.

ITEM 8. *Financial Statements and Supplementary Data.*

Reference is made to the Consolidated Financial Statements of Southern Union and subsidiaries beginning with the index thereto on page F-1.

ITEM 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.*

None.

PART III

ITEM 10. *Directors and Executive Officers of Registrant.*

There is incorporated in this Item 10 by reference the information in the Company's definitive proxy statement for the 1998 Annual Meeting of Stockholders under the captions *Board of Directors -- Board Size and Composition* and *Executive Officers and Compensation -- Executive Officers Who Are Not Directors*.

ITEM 11. *Executive Compensation.*

There is incorporated in this Item 11 by reference the information in the Company's definitive proxy statement for the 1998 Annual Meeting of Stockholders under the captions *Executive Officers and Compensation -- Executive Compensation* and *Certain Relationships*.

ITEM 12. *Security Ownership of Certain Beneficial Owners and Management.*

There is incorporated in this Item 12 by reference the information in the Company's definitive proxy statement for the 1998 Annual Meeting of Stockholders under the caption *Security Ownership*.

ITEM 13. *Certain Relationships and Related Transactions.*

There is incorporated in this Item 13 by reference the information in the Company's definitive proxy statement for the 1998 Annual Meeting of Stockholders under the caption *Certain Relationships*.

PART IV

ITEM 14. *Exhibits, Financial Statement Schedules and Reports on Form 8-K.*

- (a)(1) **Financial Statements**. Reference is made to the Index on page F-1 for a list of all financial statements filed as part of this Report.
- (a)(2) **Financial Statement Schedules**. All schedules are omitted as the required information is not applicable or the information is presented in the consolidated financial statements or related notes.
- (a)(3) **Exhibits**. Reference is made to the Exhibit Index preceding the exhibits attached hereto on page E-1 for a list of all exhibits filed as part of this Report.
- (b) **Reports on Form 8-K**. Southern Union filed no current reports on Form 8-K during the three months ended June 30, 1998.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, Southern Union has duly caused this report to be signed by the undersigned, thereunto duly authorized, on September 14, 1998.

SOUTHERN UNION COMPANY

By PETER H. KELLEY
Peter H. Kelley
President and Chief Operating Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of Southern Union and in the capacities indicated as of September 14, 1998.

<u>Signature/Name</u>	<u>Title</u>
GEORGE L. LINDEMANN*	Chairman of the Board, Chief Executive Officer and Director
JOHN E. BRENNAN*	Director
FRANK W. DENIUS*	Director
AARON I. FLEISCHMAN*	Director
KURT A. GITTER, M.D.*	Director
<u>PETER H. KELLEY</u> Peter H. Kelley	Director
ADAM M. LINDEMANN*	Director
ROGER J. PEARSON*	Director
GEORGE ROUNTREE, III*	Director
DAN K. WASSONG*	Director
<u>RONALD J. ENDRES</u> Ronald J. Endres	Executive Vice President and Chief Financial Officer
<u>DAVID J. KVAPIL</u> David J. Kvapil	Senior Vice President and Corporate Controller (Principal Accounting Officer)

*By PETER H. KELLEY
Peter H. Kelley
Attorney-in-fact

SOUTHERN UNION COMPANY

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT ACCOUNTANTS

To the Stockholders and Board of Directors of
Southern Union Company:

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of operations, cash flows and stockholders' equity present fairly, in all material respects, the financial position of Southern Union Company and its subsidiaries at June 30, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 1998, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

PricewaterhouseCoopers LLP

Austin, Texas
August 25, 1998

SOUTHERN UNION COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF OPERATIONS

	Year Ended June 30,		
	1998	1997	1996
	(thousands of dollars, except shares and per share amounts)		
Operating revenues	\$ 669,304	\$ 717,031	\$ 620,391
Gas purchase costs	<u>405,580</u>	<u>449,188</u>	<u>361,539</u>
Operating margin	263,724	267,843	258,852
Revenue related taxes	<u>(34,886)</u>	<u>(39,502)</u>	<u>(34,886)</u>
Net operating margin	228,838	228,341	223,966
Operating expenses:			
Operating, maintenance and general	107,527	109,888	107,521
Depreciation and amortization	38,439	34,829	32,982
Taxes, other than on income and revenues	<u>14,205</u>	<u>12,154</u>	<u>13,659</u>
Total operating expenses	<u>160,171</u>	<u>156,871</u>	<u>154,162</u>
Net operating revenues	<u>68,667</u>	<u>71,470</u>	<u>69,804</u>
Other income (expenses):			
Interest	(34,884)	(33,465)	(35,832)
Dividends on preferred securities of subsidiary trust	(9,480)	(9,480)	(9,480)
Write-off of regulatory assets	(8,163)	--	--
Other, net	<u>4,073</u>	<u>2,880</u>	<u>11,326</u>
Total other expenses, net	<u>(48,454)</u>	<u>(40,065)</u>	<u>(33,986)</u>
Earnings before income taxes	20,213	31,405	35,818
Federal and state income taxes	<u>7,984</u>	<u>12,373</u>	<u>14,979</u>
Net earnings available for common stock	<u>\$ 12,229</u>	<u>\$ 19,032</u>	<u>\$ 20,839</u>
Net earnings per share:			
Basic	<u>\$.44</u>	<u>\$.71</u>	<u>\$.78</u>
Diluted	<u>\$.43</u>	<u>\$.68</u>	<u>\$.76</u>
Weighted average shares outstanding:			
Basic	<u>27,580,211</u>	<u>26,886,053</u>	<u>26,758,932</u>
Diluted	<u>28,653,278</u>	<u>27,947,935</u>	<u>27,597,449</u>

See accompanying notes.

**SOUTHERN UNION COMPANY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET**

ASSETS

	June 30,	
	1998	1997
	(thousands of dollars)	
Property, plant and equipment:		
Plant in service	\$ 1,057,675	\$ 963,269
Construction work in progress	<u>7,783</u>	<u>7,970</u>
	1,065,458	971,239
Less accumulated depreciation and amortization	<u>(355,430)</u>	<u>(329,182)</u>
	710,028	642,057
Additional purchase cost assigned to utility plant, net of accumulated amortization of \$27,030,000 and \$23,082,000, respectively	<u>138,381</u>	<u>131,539</u>
Net property, plant and equipment	848,409	773,596
 Current assets:		
Accounts receivable, billed and unbilled	53,760	58,659
Inventories, principally at average cost	26,160	21,523
Investment securities	-	6,432
Prepayments and other	<u>4,747</u>	<u>9,609</u>
Total current assets	84,667	96,223
Deferred charges	94,550	109,512
Investment securities	5,000	-
Real estate	9,741	9,046
Other	5,397	2,026
 Total assets	<u>\$ 1,047,764</u>	<u>\$ 990,403</u>

See accompanying notes.

**SOUTHERN UNION COMPANY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET (Continued)**

STOCKHOLDERS' EQUITY AND LIABILITIES

	June 30.	
	1998	1997
	(thousands of dollars)	
Common stockholders' equity:		
Common stock, \$1 par value; authorized 50,000,000 shares; issued 28,252,186 shares at June 30, 1998	\$ 28,252	\$ 17,171
Premium on capital stock	252,638	225,252
Less treasury stock: 51,625 shares at cost	(794)	(794)
Retained earnings	16,738	25,169
Unrealized holding gain	--	664
	296,834	267,462
Company-obligated mandatorily redeemable preferred securities of subsidiary trust holding solely subordinated notes of Southern Union	100,000	100,000
Long-term debt and capital lease obligation	406,407	386,157
Total capitalization	803,241	753,619
Current liabilities:		
Long-term debt and capital lease obligation due within one year	1,777	687
Notes payable	1,600	1,600
Accounts payable	26,570	33,827
Federal, state and local taxes	14,017	13,699
Accrued interest	12,699	12,840
Customer deposits	17,686	17,214
Deferred gas purchase costs	12,257	3,565
Other	21,095	22,291
Total current liabilities	107,701	105,723
Deferred credits and other	74,217	77,083
Accumulated deferred income taxes	62,605	53,978
Commitments and contingencies	--	--
Total stockholders' equity and liabilities	\$ 1,047,764	\$ 990,403

See accompanying notes.

SOUTHERN UNION COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS

	Year Ended June 30,		
	1998	1997	1996
	(thousands of dollars)		
Cash flows from operating activities:			
Net earnings	\$ 12,229	\$ 19,032	\$ 20,839
Adjustments to reconcile net earnings to net cash flows from operating activities:			
Depreciation and amortization	38,439	34,829	32,982
Deferred income taxes	6,363	7,340	9,413
Provision for bad debts	5,461	11,298	5,535
Write-off of regulatory assets	8,163	--	--
Deferred interest expense	(1,671)	(3,729)	(5,664)
Gain on sale of investment securities	(1,088)	(2,545)	--
Gain on sale of various operations	--	--	(2,300)
Other	1,447	1,077	621
Changes in assets and liabilities, net of acquisitions and dispositions:			
Accounts receivable, billed and unbilled	132	(22,111)	(17,743)
Accounts payable	(7,066)	(6,978)	10,048
Taxes and other liabilities	146	(2,975)	11,021
Customer deposits	201	1,558	1,489
Deferred gas purchase costs	8,693	6,215	4,991
Inventories	(4,361)	5,691	(3,607)
Other	1,169	(708)	(160)
Net cash flows from operating activities	<u>68,257</u>	<u>47,994</u>	<u>67,465</u>
Cash flows from (used in) investing activities:			
Additions to property, plant and equipment	(77,018)	(64,463)	(59,376)
Acquisition of operations, net of cash received	6,502	(1,861)	--
Purchase of investment securities	(5,000)	(5,363)	(10,763)
Litigation settlement proceeds	--	--	4,250
Maturity of short-term investments	--	--	19,582
Increase in customer advances	3,562	2,470	3,547
Increase (decrease) in deferred charges and credits	(1,786)	6	(3,811)
Proceeds from sale of various operations	--	1,130	14,770
Proceeds from sale of land	--	1,096	--
Proceeds from sale of investment securities	6,531	13,327	--
Other	1,575	(357)	342
Net cash flows used in investing activities	<u>(65,634)</u>	<u>(54,015)</u>	<u>(31,459)</u>
Cash flows from (used in) financing activities:			
Repayment of debt and capital lease obligation	(1,309)	(640)	(72,790)
Net borrowings under revolving credit facility	--	1,600	--
Increase (decrease) in cash overdrafts	(945)	1,567	--
Other	(369)	607	656
Net cash flows from (used in) financing activities	<u>(2,623)</u>	<u>3,134</u>	<u>(72,134)</u>
Decrease in cash and cash equivalents	--	(2,887)	(36,128)
Cash and cash equivalents at beginning of year	--	2,887	39,015
Cash and cash equivalents at end of year	<u>\$ --</u>	<u>\$ --</u>	<u>\$ 2,887</u>

Cash paid for interest, net of amounts capitalized, in 1998, 1997 and 1996 was \$33,997,000, \$32,282,000 and \$36,893,000, respectively. Cash paid for income taxes in 1998, 1997 and 1996 was \$4,511,000, \$5,871,000 and \$11,000, respectively.

See accompanying notes.

SOUTHERN UNION COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

	<u>Common Stock, \$1 Par Value</u>	<u>Premium on Capital Stock</u>	<u>Treasury Stock, at Cost (thousands of dollars)</u>	<u>Retained Earnings</u>	<u>Unrealized Holding Gain (Loss)</u>	<u>Total</u>
Balance July 1, 1995	\$ 11,570	\$ 198,819	\$ (794)	\$ 16,069	\$ --	\$225,664
Net earnings	--	--	--	20,839	--	20,839
5% stock dividend	576	10,701	--	(11,277)	--	--
Four-for-three stock split	4,054	(4,054)	--	--	--	--
Change in unrealized holding gain or loss	--	--	--	--	(1,244)	(1,244)
Exercise of stock options	<u>75</u>	<u>581</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>656</u>
Balance June 30, 1996	16,275	206,047	(794)	25,631	(1,244)	245,915
Net earnings	--	--	--	19,032	--	19,032
5% stock dividend	813	18,681	--	(19,494)	--	--
Change in unrealized holding gain or loss	--	--	--	--	1,908	1,908
Exercise of stock options	<u>83</u>	<u>524</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>607</u>
Balance June 30, 1997	17,171	225,252	(794)	25,169	664	267,462
Net earnings	--	--	--	12,229	--	12,229
5% stock dividend	856	19,802	--	(20,658)	--	--
Three-for-two stock split	9,400	(9,400)	--	(2)	--	(2)
Issuance of stock for acquisition .	756	17,285	--	--	--	18,041
Change in unrealized holding gain or loss	--	--	--	--	(664)	(664)
Exercise of stock options	<u>69</u>	<u>(301)</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>(232)</u>
Balance June 30, 1998	<u>\$ 28,252</u>	<u>\$ 252,638</u>	<u>\$ (794)</u>	<u>\$ 16,738</u>	<u>\$ --</u>	<u>\$296,834</u>

See accompanying notes.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

I Summary of Significant Accounting Policies

Operations Southern Union Company (*Southern Union* and, together with its wholly-owned subsidiaries, the *Company*), is a public utility primarily engaged in the distribution and sale of natural gas to residential, commercial and industrial customers. Subsidiaries of Southern Union also market natural gas to end-users, distribute propane, operate natural gas pipeline systems and sell commercial gas air conditioning and other gas-fired engine-driven applications. Certain subsidiaries own or hold interests in real estate and other assets, which are primarily used in the Company's utility business. Substantial operations of the Company are subject to regulation.

Principles of Consolidation The consolidated financial statements include the accounts of Southern Union and its wholly-owned subsidiaries. All significant intercompany accounts and transactions are eliminated in consolidation. All dollar amounts in the tables herein, except per share amounts, are stated in thousands unless otherwise indicated.

Gas Utility Revenues and Gas Purchase Costs Gas utility customers are billed on a monthly-cycle basis. The related cost of gas is matched with cycle-billed revenues through operation of purchased gas adjustment provisions in tariffs approved by the regulatory agencies having jurisdiction. Revenues from gas delivered but not yet billed are accrued, along with the related gas purchase costs and revenue-related taxes. The distribution and sale of natural gas in Texas and Missouri contributed in excess of 85% of the Company's total revenue, net earnings and identifiable assets in both 1998 and 1997. Four suppliers provided 45%, 44% and 43% of the Company's gas purchases in 1998, 1997 and 1996, respectively.

Credit Risk Concentrations of credit risk in trade receivables are limited due to the large customer base with relatively small individual account balances. In addition, Company policy requires a deposit from certain customers. The Company has recorded an allowance for doubtful accounts totaling \$8,488,000, \$10,986,000, \$4,000,000 and \$2,100,000 at June 30, 1998, 1997, 1996 and 1995, respectively. The allowance for doubtful accounts is increased for estimated uncollectible accounts and reduced for the write-off of trade receivables.

Fair Value of Financial Instruments The carrying amounts reported in the balance sheet for cash and cash equivalents, accounts receivable, accounts payable and notes payable approximates their fair value. The fair value of the Company's investment securities and long-term debt is estimated using current market quotes and other estimation techniques.

Inventories Inventories consist of natural gas in underground storage and materials and supplies. Natural gas in underground storage of \$20,545,000 and \$17,171,000 at June 30, 1998 and 1997, respectively, consists of 9,118,000 and 7,785,000 British thermal units, respectively.

Earnings Per Share The Financial Accounting Standards Board (FASB) recently issued a standard, *Earnings Per Share*, which replaces the previously reported primary and fully diluted earnings per share with a basic and diluted earnings per share presentation. Unlike primary earnings per share, basic earnings per share excludes any dilutive effects of options and warrants. Diluted earnings per share is very similar to the previously reported fully diluted earnings per share. All earnings per share amounts for all periods have been presented, and where necessary, restated to conform to the new standard. All share and per share data have been restated for all stock dividends and stock splits unless otherwise stated.

New Pronouncements The FASB recently issued *Employers' Disclosures about Pensions and Other Postretirement Benefits* which revises employers' disclosures about pension and other postretirement benefit plans. The Company is required to adopt the provisions of this standard by June 30, 1999.

The FASB also issued *Reporting Comprehensive Income and Disclosures about Segments of an Enterprise and Related Information*, which establish procedures for reporting and display of comprehensive income and its components, and certain disclosures about segment information in interim and annual financial statements and related information about products, services, geographic areas and major customers, respectively. The Company will adopt

SOUTHERN UNION COMPANY AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

the provisions of these standards for the fiscal year ending June 30, 1999, but does not expect the adoption thereof to have a material effect on the Company's financial position, results of operations or cash flows.

Use of Estimates The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

II Acquisitions and Divestiture

Effective December 31, 1997, the Company acquired Atlantic Utilities Corporation and Subsidiaries (Atlantic) for 755,650 pre-split shares of common stock valued at \$18,041,000 and cash of \$4,436,000. Atlantic is operated as South Florida Natural Gas, a natural gas division of Southern Union, and Atlantic Gas Corporation, a propane subsidiary of the Company. Atlantic currently serves 4,800 customers in central Florida. The assets of Atlantic were included in the Company's consolidated balance sheet at January 1, 1998 as well as Atlantic's results of operations which have been included in the Company's statements of consolidated operations and cash flows since January 1, 1998. On the date of acquisition, Atlantic had \$11,683,000 of cash and cash equivalents. The acquisition was accounted for using the purchase method. The additional purchase cost to be assigned to utility plant, pending final determination of the fair value of the assets acquired and liabilities assumed, of approximately \$10,000,000 reflects the excess of the purchase price over the historical book carrying value of the net assets acquired. The additional purchase cost is amortized on a straight-line basis over forty years.

On July 23, 1997 two subsidiaries of Southern Union acquired a 42% equity ownership in a natural gas distribution company and other related operations currently serving 17,500 customers in Piedras Negras, Mexico for \$2,700,000. This system is across the border from the Company's Eagle Pass, Texas service area. On September 8, 1997, the Company purchased a 45-mile intrastate pipeline, which will augment the Company's gas supply to the city of Eagle Pass and, subject to necessary regulatory approvals, ultimately Piedras Negras.

On August 30, 1996, SUPro Energy Company, a wholly-owned subsidiary of the Company, purchased certain propane distribution operations in El Paso, Texas and on June 30, 1997, acquired propane operations located in and around Alpine, Texas. These acquisitions which serve 3,600 customers were for \$1,861,000 in cash and the assumption of \$1,475,000 in long-term debt.

On May 1, 1996, Southern Union Company sold certain gas distribution operations of the Company in the Texas and Oklahoma Panhandles and Western Gas Interstate Company (WGI), a former wholly-owned subsidiary of the Company, exclusive of the Del Norte interconnect operation which transports natural gas into Mexico, for \$15,900,000.

III Write-Off of Regulatory Assets

During 1998, the Company was impacted by pre-tax non-cash write-offs totaling \$8,163,000 of previously recorded regulatory assets. Pursuant to a 1989 Missouri Public Service Commission (MPSC) order, Missouri Gas Energy is engaged in a major gas safety program. In connection with this program, the MPSC issued an accounting authority order in 1994 which authorized Missouri Gas Energy to defer carrying costs at a rate of 10.54%. The MPSC rate order of January 22, 1997, however, retroactively reduced the 10.54% carrying cost rate used since early 1994 to an Allowance for Funds Used During Construction (AFUDC) rate of approximately 6%. The Company filed an appeal of this portion of the rate order in the Missouri State Court of Appeals, Western District, and on August 18, 1998 was notified that the appeal was denied. This resulted in a one-time non-cash write-off of \$5,942,000 of previously deferred costs as of June 30, 1998. See *Commitments and Contingencies*.

On August 21, 1998, Missouri Gas Energy was notified by the MPSC of its decision to grant a rate increase which, among other things, disallowed certain previously recorded deferred costs associated with the rate filing, requiring an additional pre-tax non-cash write-off of \$2,221,000. Though the Company has requested a rehearing on significant

SOUTHERN UNION COMPANY AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

portions of these disallowances, generally accepted accounting principles require the Company to immediately record this charge to earnings which Southern Union did as of June 30, 1998.

IV Other Income, Net

Other income of \$4,073,000 in 1998 included: \$1,671,000 related to the deferral of interest and other expenses associated with the Missouri Gas Energy Safety Program; realized gains on the sale of investment securities of \$1,088,000; and net rental income of Lavaca Realty Company (Lavaca Realty), the Company's real estate subsidiary, of \$1,119,000.

Other income of \$2,880,000 in 1997 included: \$3,729,000 related to the deferral of interest and other expenses associated with the Missouri Gas Energy Safety Program; realized gains on the sale of investment securities of \$2,545,000; and net rental income of Lavaca Realty, of \$1,329,000. This was partially offset by \$2,125,000 for the settlement of complaints brought by the Missouri Office of Public Counsel and the Missouri Public Service Commission (MPSC) for certain billing errors primarily from the 1996/1997 winter heating season; the write-off of \$1,750,000 of acquisition-related costs as a result of termination of various acquisition activities; and a \$257,000 expense associated with the donation of emissions analysis equipment and software to a Texas university.

Other income of \$11,326,000 in 1996 included: \$5,664,000 related to the deferral of interest and other expenses associated with the Missouri Gas Energy Safety Program; \$2,300,000 pre-tax gain on the sale of WGI and other operations; investment interest and interest on notes receivable of \$2,051,000; net rental income of Lavaca Realty of \$1,392,000; and \$1,581,000 in net gains from the repurchase of Senior Notes. This was partially offset by losses of \$470,000 on the sale of undeveloped real estate.

V Cash Flow Information

The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. Short-term investments are highly liquid investments with maturities of more than three months when purchased, and are carried at cost, which approximates market. The Company places its temporary cash investments with a high credit quality financial institution which, in turn, invests the temporary funds in a variety of high-quality short-term financial securities.

Under the Company's cash management system, checks issued but not presented to banks frequently result in overdraft balances for accounting purposes and are classified in accounts payable in the consolidated balance sheet.

VI Earnings Per Share

During the three-year period ended June 30, 1998, no adjustments were required in net earnings available for common stock for the earnings per share calculations. Average shares outstanding for basic earnings per share were 27,580,211, 26,886,053 and 26,758,932 for the year ended June 30, 1998, 1997 and 1996, respectively. Diluted earnings per share includes average shares outstanding as well as common stock equivalents from stock options and warrants. Common stock equivalents were 1,073,067, 1,061,882 and 838,517 for the year ended June 30, 1998, 1997 and 1996, respectively.

**SOUTHERN UNION COMPANY AND SUBSIDIARIES
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VII Property, Plant and Equipment

Plant Plant in service and construction work in progress are stated at original cost net of contributions in aid of construction. The cost of additions includes an allowance for funds used during construction and applicable overhead charges. Gain or loss is recognized upon the disposition of significant utility properties and other property constituting operating units. Gain or loss from minor dispositions of property is charged to accumulated depreciation and amortization. The Company capitalizes the cost of significant internally-developed computer software systems and amortizes the cost over the expected useful life. See *Debt and Capital Lease*.

	June 30,	
	1998	1997
Distribution plant	\$ 984,580	\$ 919,998
General plant	106,444	74,375
Other	16,172	15,872
Total plant	1,107,196	1,010,245
Less contributions in aid of construction	(49,521)	(46,976)
Plant in service	1,057,675	963,269
Construction work in progress	7,783	7,970
	1,065,458	971,239
Less accumulated depreciation and amortization	(355,430)	(329,182)
	710,028	642,057
Additional purchase cost assigned to utility plant, net	138,381	131,539
Net property, plant and equipment	\$ 848,409	\$ 773,596

Acquisitions of rate-regulated entities are recorded at the historical book carrying value of utility plant. On December 31, 1997, Atlantic was acquired in which historical utility plant and equipment had a cost and accumulated depreciation and amortization of \$5,253,000 and \$2,540,000, respectively. Additional purchase cost assigned to utility plant is the excess of the purchase price over the book carrying value of the net assets acquired. In general, the Company has not been allowed recovery of additional purchase cost assigned to utility plant in rates. Periodically, the Company evaluates the carrying value of its additional purchase cost assigned to utility plant, long-lived assets, capital leases and other identifiable intangibles by comparing the anticipated future operating income from the businesses giving rise to the respective asset with the original cost or unamortized balance. No impairment has been indicated or is expected at June 30, 1998.

Depreciation and Amortization Depreciation of utility plant is provided at an average straight-line rate of approximately 3% per annum of the cost of such depreciable properties less applicable salvage. Franchises are amortized over their respective lives. Depreciation and amortization of other property is provided at straight-line rates estimated to recover the costs of the properties, after allowance for salvage, over their respective lives. Internally-developed computer software system costs are amortized over various regulatory-approved periods. Amortization of additional purchase cost assigned to utility plant is provided on a straight-line basis over forty years unless the Company's regulators have provided for the recovery of the additional purchase cost in rates, in which case the Company's policy is to utilize the amortization period which follows the rate recovery period.

Depreciation of property, plant and equipment in 1998, 1997, and 1996 was \$34,477,000, \$31,051,000 and \$29,264,000, respectively.

VIII Investment Securities

At June 30, 1998, all securities owned by the Company are accounted for under the cost method. These securities consist of preferred stock in a non-public company. Realized gains and losses on sales of investments, as determined

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on a specific identification basis, are included in the Consolidated Statement of Operations when incurred, and dividends are recognized as income when received.

At June 30, 1997, all securities owned by the Company were classified as available for sale. Accordingly, these securities are stated at fair value, with unrealized gains and losses reported in a separate component of common stockholders' equity. As of June 30, 1997, investment securities consisted of common stock with a specific cost of \$5,443,000 and a fair value of \$6,432,000. The unrealized holding gain, net of related income taxes and included as a separate component of common stockholders' equity, totaled, \$643,000.

As of June 30, 1997, the Company had short sales of investment securities and recorded a prepayment for the anticipated proceeds of \$6,599,000. The related payable of \$6,566,000, based on fair value of the investment securities, was recorded in other current liabilities. The unrealized holding gain, net of related income taxes and included as a separate component of common stockholders' equity, totaled \$21,000 at June 30, 1997.

IX Stockholders' Equity

Stock Splits and Dividends On December 10, 1997, December 10, 1996 and November 27, 1995, Southern Union distributed its annual 5% common stock dividend to stockholders of record on November 21, 1997, November 22, 1996 and November 15, 1995, respectively. A portion of the 5% stock dividend distributed on November 27, 1995 was characterized as a distribution of capital due to the level of the Company's retained earnings available for distribution as of the declaration date. On July 13, 1998, Southern Union distributed a three-for-two stock split in the form of a 50% stock dividend to stockholders of record on June 30, 1998. On March 11, 1996, the Company distributed a four-for-three stock split in the form of a 33 $\frac{1}{3}$ % stock dividend, to stockholders of record on February 23, 1996. Unless otherwise stated, all per share and share data included herein have been restated to give effect to the dividends and splits.

Common Stock The Company maintains its 1992 Long-Term Stock Incentive Plan (1992 Plan) under which options to purchase 3,313,690 shares were provided to be granted to officers and key employees at prices not less than the fair market value on the date of grant. The 1992 Plan allows for the granting of stock appreciation rights, dividend equivalents, performance shares and restricted stock. The Company also had an incentive stock option plan (1982 Plan) which provided for the granting of 787,500 options, until December 31, 1991. Upon exercise of an option granted under the 1982 Plan, the Company may elect, instead of issuing shares, to make a cash payment equal to the difference at the date of exercise between the option price and the market price of the shares as to which such option is being exercised. Options granted under both the 1992 Plan and the 1982 Plan are exercisable for periods of ten years from the date of grant or such lesser period as may be designated for particular options, and become exercisable after a specified period of time from the date of grant in cumulative annual installments. Options typically vest 20% per year for five years but may be a lesser or greater period as designated for particular options.

The Company accounts for its incentive plans under an Accounting Principles Board opinion, *Accounting for Stock Issued to Employees*. As a result, the Company recorded no compensation expense for 1998, 1997 and 1996. During 1997, the Company adopted the FASB standard, *Accounting for Stock-Based Compensation*, for footnote disclosure purposes only. Had compensation cost for these incentive plans been determined consistent with this standard, the Company's net income and diluted earnings per share would have been \$11,141,000 and \$.39, respectively, in 1998, \$18,489,000 and \$.66, respectively, in 1997 and \$20,616,000 and \$.75, respectively, in 1996. Because this standard has not been applied to options granted prior to July 1, 1995, the resulting pro forma compensation cost may not be representative of that to be expected in future years.

SOUTHERN UNION COMPANY AND SUBSIDIARIES
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The fair value of each option is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions used for grants in 1998, 1997 and 1996, respectively: dividend yield of nil for all years; volatility of 19.5%, 21% and 25%; risk-free interest rate of 5.5%, 6.2% and 6.6%; and expected life outstanding of 5.5 to 7.2 years, 5.5 to 7.2 years and 3.5 to 7.0 years.

	1992 Plan		1982 Plan	
	Shares Under Option	Weighted Average Exercise Price	Shares Under Option	Weighted Average Exercise Price
Outstanding July 1, 1995	1,039,315	\$ 5.93	595,261	\$ 3.39
Granted	475,928	9.68	--	--
Exercised	(56,160)	5.47	(105,835)	3.36
Canceled	(74,820)	6.67	--	--
Outstanding June 30, 1996	1,384,263	7.20	489,426	3.39
Granted	446,235	14.47	--	--
Exercised	(55,494)	6.26	(77,653)	3.39
Canceled	(11,938)	7.25	--	--
Outstanding June 30, 1997	1,763,066	9.07	411,773	3.39
Granted	674,555	18.66	--	--
Exercised	(77,081)	4.93	(80,961)	3.39
Canceled	(19,622)	13.87	--	--
Outstanding June 30, 1998	<u>2,340,918</u>	11.93	<u>330,812</u>	3.39

The following table summarizes information about stock options outstanding under the 1992 Plan at June 30, 1998:

Options Outstanding				Options Exercisable	
Range of Exercise Prices	Number of Options	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
\$ 0.00 - \$ 5.00	371,787	4.3 years	\$ 4.27	371,787	\$ 4.27
5.01 - 10.00	798,248	6.5 years	8.53	455,673	8.16
10.01 - 15.00	483,636	8.3 years	13.93	109,134	13.54
15.01 - 20.00	682,285	9.9 years	18.60	--	--
20.01 - 25.00	4,962	5.0 years	20.53	--	--
	<u>2,340,918</u>			<u>936,594</u>	

The shares exercisable under the 1992 Plan and the corresponding weighted average exercise price at June 30, 1998, 1997 and 1996 were 936,594 at \$7.24; 686,598 at \$6.12; and 464,573 at \$5.55, respectively. The shares exercisable under the 1982 Plan and the corresponding weighted average exercise price at June 30, 1998, 1997 and 1996 were 330,812 at \$3.39; 411,773 at \$3.39; and 489,426 at \$3.39, respectively. The weighted average remaining contractual life of options outstanding under the 1982 Plan at June 30, 1998 was 1.9 years. There were 768,720 shares available for future option grants under the 1992 Plan at June 30, 1998. No shares were available for future option grants under the 1982 Plan at June 30, 1998.

On February 10, 1994, Southern Union granted a warrant which expires on February 10, 2004, to purchase up to 91,162 shares of Common Stock at an exercise price of \$7.61 to the Company's outside legal counsel.

Retained Earnings Under the most restrictive provisions in effect, as a result of the sale of Senior Notes, Southern Union will not declare or pay any cash or asset dividends on common stock (other than dividends and distributions payable solely in shares of its common stock or in rights to acquire its common stock) or acquire or retire any shares of Southern Union's common stock, unless no event of default exists and the Company meets certain financial

**SOUTHERN UNION COMPANY AND SUBSIDIARIES
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ratio requirements. In addition, Southern Union's charter relating to the issuance of preferred stock limits the payment of cash or asset dividends on capital stock.

X Preferred Securities of Subsidiary Trust

On May 17, 1995, Southern Union Financing I (Subsidiary Trust), a consolidated wholly-owned subsidiary of Southern Union, issued \$100,000,000 of 9.48% Trust Originated Preferred Securities (Preferred Securities). In connection with the Subsidiary Trust's issuance of the Preferred Securities and the related purchase by Southern Union of all of the Subsidiary Trust's common securities (Common Securities), Southern Union issued to the Subsidiary Trust \$103,092,800 principal amount of its 9.48% Subordinated Deferrable Interest Notes, due 2025 (Subordinated Notes). The sole assets of the Subsidiary Trust are the Subordinated Notes. The interest and other payment dates on the Subordinated Notes correspond to the distribution and other payment dates on the Preferred Securities and the Common Securities. Under certain circumstances, the Subordinated Notes may be distributed to holders of the Preferred Securities and holders of the Common Securities in liquidation of the Subsidiary Trust. The Subordinated Notes are redeemable at the option of the Company on or after May 17, 2000, at a redemption price of \$25 per Subordinated Note plus accrued and unpaid interest. The Preferred Securities and the Common Securities will be redeemed on a pro rata basis to the same extent as the Subordinated Notes are repaid, at \$25 per Preferred Security and Common Security plus accumulated and unpaid distributions. Southern Union's obligations under the Subordinated Notes and related agreements, taken together, constitute a full and unconditional guarantee by Southern Union of payments due on the Preferred Securities. As of June 30, 1998 and 1997, 4,000,000 shares of Preferred Securities were outstanding.

XI Debt and Capital Lease

	June 30,	
	1998	1997
7.60% Senior Notes, due 2024	\$ 384,515	\$ 384,515
Other	23,669	2,329
Total long-term debt	\$ 408,184	\$ 386,844

The maturities of long-term debt for each of the next five years ending June 30 are: 1999 -- \$1,777,000; 2000 -- \$1,632,000; 2001 -- \$1,734,000; 2002 -- \$1,852,000; 2003 -- \$12,159,000 and thereafter -- \$389,030,000.

Senior Notes On January 31, 1994, Southern Union completed the sale of the \$475,000,000, 7.60% Senior Debt Securities (Senior Notes). The net proceeds from the sale, together with the net proceeds from a \$50,000,000 common stock subscription rights offering (Rights Offering) completed on December 31, 1993 and working capital from operations, were used to: (i) fund the acquisition of Missouri Gas Energy; (ii) repay \$59,300,000 of borrowings under the revolving credit facility; and (iii) refinance \$105,000,000 aggregate principal amount of various notes and debentures and the related premiums of \$13,700,000 resulting from the early extinguishment of such notes and debentures.

During 1996, \$75,485,000 of Senior Notes were repurchased at prices ranging from \$922 to \$985 per \$1,000 note resulting in a net pre-tax gain of \$1,581,000. Debt issuance costs and premiums on the early extinguishment of debt are accounted for in accordance with that required by its various regulatory bodies having jurisdiction over the Company's operations. The Company recognizes gains or losses on the early extinguishment of debt to the extent it is provided for by its regulatory authorities and in some cases such gains or losses are deferred and amortized over the term of the new or replacement debt issues.

The Senior Notes traded at \$1,061 and \$1,026 (per \$1,000 note) on June 30 and July 31, 1998, respectively, as quoted by a major brokerage firm. The carrying amount of long-term debt at June 30, 1998 and 1997 was \$408,184,000 and \$386,844,000, respectively. The fair value of long-term debt at June 30, 1998 and 1997 was \$431,628,000 and \$373,770,000, respectively.

SOUTHERN UNION COMPANY AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Capital Lease The Company began installing an Automated Meter Reading (AMR) system at Missouri Gas Energy during fiscal year 1998 which was substantially completed in first quarter of fiscal year 1999. The installation of the AMR system involved an investment of \$30,550,000 which is accounted for as a capital lease obligation. During 1998, the Company recorded an increase in plant and long-term debt of \$22,151,000. As of June 30, 1998, the capital lease obligation outstanding was \$21,652,000. This system will improve meter reading accuracy and provide electronic accessibility to meters in residential customers' basements, thereby assisting in the reduction of the number of estimated bills. Depreciation on the AMR system is provided at an average straight-line rate of approximately 5% per annum of the cost of such property.

Credit Facilities The Company has availability under a \$100,000,000 revolving credit facility (Revolving Credit Facility) underwritten by a syndicate of banks. The Company has additional availability under uncommitted line of credit facilities (Uncommitted Facilities) with various banks. Covenants under the Revolving Credit Facility allow for up to \$35,000,000 of borrowings under Uncommitted Facilities at any one time. Borrowings under these facilities are available for Southern Union's working capital, letter of credit requirements and other general corporate purposes. The facilities are uncollateralized and have no borrowing base limitations as long as the Senior Notes meet certain rating criteria. The Company may use up to \$40,000,000 of the Revolving Credit Facility to finance future acquisitions. These facilities contain covenants with respect to financial parameters and ratios, total debt limitations, restrictions as to dividend payments, stock reacquisitions, certain investments and additional liens. The facilities expire on December 31, 1999. The Revolving Credit Facility is subject to a commitment fee based on the rating of the Senior Notes. As of June 30, 1998, the commitment fee was an annualized .15% on the unused balance. The interest rate on borrowings on the Revolving Credit Facility is calculated based on a formula using the LIBOR or prime interest rates. The average interest rate under the facilities was 6.1% for the years ended June 30, 1998 and 1997. A \$1,600,000 balance was outstanding under the facilities at both June 30, 1998 and 1997. A balance of \$7,400,000 was outstanding under the facilities at July 31, 1998.

XII Employee Benefits

Defined Contribution Plan The Company provides a Savings Plan available to all employees. Since January 1, 1997, the Company contributes \$.50 of Company stock for each \$1.00 contributed by a non-Missouri Gas Energy participant up to 5% of the employee's salary. Additionally, the Company contributes \$.75 of Company stock for each \$1.00 contributed by a non-Missouri Gas Energy participant from 6% to 10% of the employee's salary. For Missouri Gas Energy non-union employees, the Company contributes \$.50 of Company stock for each \$1.00 contributed by such a participant up to 5% of the employee's salary and the Company contributes \$.75 of Company stock for each \$1.00 contributed by such a participant from 6% to 8% of the employee's salary. For Missouri Gas Energy union employees, the Company contributes \$.50 of Company stock for each \$1.00 contributed by such a participant up to 7% of the employee's salary. Company contributions are 100% vested after six years of continuous service. Company contributions to the plan during 1998, 1997 and 1996, were \$1,656,000, \$1,476,000 and \$1,425,000, respectively.

Postemployment Benefits Certain postemployment benefits such as disability and health care continuation coverage provided to former or inactive employees after employment but before retirement, are accrued if attributable to an employee's previously rendered service. The Company has recorded a regulatory asset to the extent it intends to file rate applications to include such costs in rates and such recovery is probable. As of June 30, 1998 and 1997, the Company has recorded a regulatory asset and a related liability of \$1,343,000 and \$1,100,000, respectively.

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Postretirement Benefits Other than Pensions

	<u>1998</u>	<u>1997</u>	<u>1996</u>
Service cost of benefits earned during the year	\$ 278	\$ 282	\$ 313
Interest cost on benefit obligations	2,811	2,772	2,982
Actual return on plan assets	(76)	(31)	(24)
Amortization of transition obligation	224	224	224
Net amortization and deferral	<u>(1,432)</u>	<u>(1,115)</u>	<u>(195)</u>
Net postretirement benefit cost	<u>\$ 1,805</u>	<u>\$ 2,132</u>	<u>\$ 3,300</u>
Accumulated postretirement benefit obligation:			
Retirees		<u>\$ 29,804</u>	<u>\$ 28,713</u>
Other fully eligible participants		3,410	2,424
Other active participants		<u>4,850</u>	<u>4,811</u>
Accumulated benefit obligation		38,064	35,948
Plan assets at fair value		<u>(2,128)</u>	<u>(863)</u>
Accumulated benefit obligations in excess of plan assets		35,936	35,085
Unrecognized net transition obligation		(3,244)	(3,412)
Unrecognized prior service cost		1,102	1,207
Unrecognized net gain		<u>4,663</u>	<u>7,552</u>
Accrued postretirement benefit cost		<u>\$ 38,457</u>	<u>\$ 40,432</u>

Postretirement medical and other benefit liabilities are accrued on an actuarial basis during the years an employee provides services. Prior to 1997, Missouri Gas Energy recorded a deferral of postretirement medical expense in excess of cash paid per an accounting authority order approved by the MPSC. These deferrals were to be amortized to expense and were to be fully offset by the net income stream generated from a company-owned life insurance (COLI) plan. Legislation passed in 1996 by Congress eliminated the tax advantages afforded to COLI plans, and the Missouri Gas Energy COLI program was terminated in February 1997. Additionally, the State of Missouri passed legislation which provides for prospective recognition by the MPSC of postretirement medical and benefit costs on an accrual basis when funded. Amortization of deferrals recorded prior to the termination of the COLI are currently included in Missouri Gas Energy rates. The Company amortizes the transition obligation over an allowed 20-year period. Fluctuations in the stock market could impact future plan asset investment returns and ultimately net pension expense.

The significant features of the plan include the payment of a portion of the medical benefit costs for individuals (and their dependents) who are: (i) employees or retirees of Missouri Gas Energy; (ii) non-Missouri Gas Energy retirees who retired prior to January 1, 1993; and (iii) non-Missouri Gas Energy employees (and their dependents) who elected to retire during the first quarter of 1993. For active non-Missouri Gas Energy employees hired prior to January 1, 1993, benefits are provided only to retirees and only until eligibility for Medicare (age 65). The cost-sharing provisions for medical care benefits include an escalation in the non-Missouri Gas Energy retirees' share of claims obligations that is expected to follow the trend of claims net of Medicare reimbursements. The non-Missouri Gas Energy employees plan was amended during 1993 to substantially modify the cost-sharing provisions to decrease the employer's share of expected future claims and make certain other plan changes. The plan for Missouri Gas Energy employees and retirees provides payment of a portion of the medical benefit costs for individuals and their dependents. The cost sharing provisions include an escalation in the Missouri Gas Energy retirees share of claims that is expected to follow the trend of claims net of Medicare, subject to an overall limit on employer expenditures.

The weighted average assumed discount rate used to measure the accumulated postretirement benefit obligation was 7.75% for the year ended June 30, 1998 and 1997. The weighted average expected long-term rate of return on plan assets was assumed to be 8% on an after-tax basis. The annual assumed rate of increase in the health care cost trend rate for 1998 was 7.25% per year, gradually decreasing thereafter to 6% in year eight and thereafter, of the

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projection. The health care cost trend rate assumption has a significant effect on the amounts reported. Increasing the assumed health care cost trend rate by one percent for each future year would increase the aggregate of the service and interest cost components of the net periodic postretirement health care benefit cost by \$34,000 and would increase the accumulated postretirement benefit obligation for health care benefits by \$368,000. Assets held in the separate account within the retirement plan include cash and bond and stock funds. Non-benefit liabilities are limited to expenses associated with plan operation and administration.

Defined Benefit Plan The Company maintains two trustee non-contributory defined benefit retirement plans which cover substantially all employees. Plan A covers those Company employees who are not employed by Missouri Gas Energy and Plan B covers those employees who are employed by Missouri Gas Energy. The Company funds the plans' cost in accordance with federal regulations, not to exceed the amounts deductible for income tax purposes. The plans' assets are invested in cash and bond and stock funds.

Net pension expense for the years ended June 30, 1998, 1997 and 1996 consisted of the following:

	Plan A			Plan B		
	1998	1997	1996	1998	1997	1996
Service cost of benefits earned during the year	\$ 1,431	\$ 1,405	\$ 1,442	\$ 1,550	\$ 1,509	\$ 1,640
Interest cost on projected benefit obligations . . .	2,970	2,759	2,483	7,596	7,487	7,355
Actual return on plan assets	(5,693)	(6,473)	(4,204)	(17,076)	(20,797)	(18,669)
Net amortization and deferral	2,735	4,121	2,277	5,021	12,025	11,556
Net pension expense (income)	<u>\$ 1,443</u>	<u>\$ 1,812</u>	<u>\$ 1,998</u>	<u>\$ (2,909)</u>	<u>\$ 224</u>	<u>\$ 1,882</u>
Actuarial assumptions:						
Weighted average discount rate	7.25%	7.75%	7.75%	7.25%	7.75%	7.75%
Rate of increase in future compensation levels	5.62%	5.62%	5.62%	5.8%	5.8%	5.8%
Weighted average expected long-term rate of return	8%	8%	7.75%	8%	8%	7.75%

	Plan A		Plan B	
	1998	1997	1998	1997
Actuarial present value of benefit obligations:				
Vested benefits	\$ 32,950	\$ 29,738	\$ 95,124	\$ 88,541
Nonvested benefits	1,188	1,184	1,245	1,086
Accumulated benefit obligations	34,138	30,922	96,369	89,627
Effect of future salary increases	8,056	5,933	7,447	7,113
Projected benefit obligation	42,194	36,855	103,816	96,740
Plan assets at fair value	(41,907)	(36,931)	(122,318)	(112,574)
Projected benefit obligation less plan assets	287	(76)	(18,502)	(15,834)
Unrecognized net transition asset	354	427	--	--
Unrecognized prior service cost	(1,385)	(1,515)	(1,020)	(1,103)
Unrecognized net gain	4,280	4,555	17,728	17,324
Accrued retirement plan liabilities (assets)	<u>\$ 3,536</u>	<u>\$ 3,391</u>	<u>\$ (1,794)</u>	<u>\$ 387</u>

The actuarial computations for the determination of accumulated and projected benefit obligations are based on the projected unit credit method. Prior service cost is being amortized on a straight-line basis over the average remaining expected future service of participants present at the time of amendment.

The Company also maintains a supplemental non-contributory defined benefit retirement plan which covers certain executive employees. The purpose of the supplemental plan is to provide part or all of those defined benefit plan

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benefits which are not payable to certain employees under the primary plan. The net pension cost of the supplemental plan for each of the three years ended June 30, 1998 was not significant.

XIII Taxes on Income

	<u>Year Ended June 30.</u>		
	<u>1998</u>	<u>1997</u>	<u>1996</u>
Current:			
Federal	\$ 1,381	\$ 4,437	\$ 4,960
State	<u>240</u>	<u>596</u>	<u>606</u>
	1,621	5,033	5,566
Deferred:			
Federal	5,984	6,690	8,563
State	<u>379</u>	<u>650</u>	<u>850</u>
	<u>6,363</u>	<u>7,340</u>	<u>9,413</u>
Total provision	<u>\$ 7,984</u>	<u>\$ 12,373</u>	<u>\$ 14,979</u>

Deferred credits and other liabilities also include \$593,000 and \$629,000 of unamortized deferred investment tax credit as of June 30, 1998 and 1997, respectively.

Deferred income taxes result from temporary differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities.

	<u>June 30.</u>	
	<u>1998</u>	<u>1997</u>
Deferred tax assets:		
Postretirement benefits	\$ 1,079	\$ 2,053
Bad debt reserves	--	2,643
Estimated alternative minimum tax credit	10,554	7,890
Insurance accruals	3,074	2,599
Unrealized holding gain on securities	--	(357)
Other	<u>1,230</u>	<u>1,266</u>
Total deferred tax assets	<u>15,937</u>	<u>16,094</u>
Deferred tax liabilities:		
Property, plant and equipment	(65,564)	(57,839)
Unamortized debt expense	(5,270)	(5,492)
Other	<u>(5,330)</u>	<u>(3,955)</u>
Total deferred tax liabilities	<u>(76,164)</u>	<u>(67,286)</u>
Net deferred tax liability	(60,227)	(51,192)
Less current tax assets	<u>2,378</u>	<u>2,786</u>
Accumulated deferred income taxes	<u>\$ (62,605)</u>	<u>\$ (53,978)</u>

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The Company accounts for income taxes utilizing the liability method which bases the amounts of current and future tax assets and liabilities on events recognized in the financial statements and on income tax laws and rates existing at the balance sheet date.

	<u>Year Ended June 30.</u>		
	<u>1998</u>	<u>1997</u>	<u>1996</u>
Computed statutory tax expense at 35%	\$ 7,075	\$ 10,992	\$ 12,536
Changes in taxes resulting from:			
State income taxes, net of federal income tax benefit	402	811	947
Acquisition adjustment related to assets sold	--	--	1,096
Amortization of acquisition adjustment	723	724	884
Research and experimentation credit	--	--	(400)
Other	<u>(216)</u>	<u>(154)</u>	<u>(84)</u>
Actual tax expense	<u>\$ 7,984</u>	<u>\$ 12,373</u>	<u>\$ 14,979</u>

XIV Utility Regulation and Rates

On August 21, 1998, MGE was notified by the MPSC of its decision to grant a \$13,300,000 annual increase to revenue effective on September 2, 1998.

On April 13, 1998 Southern Union Gas filed for a \$2,228,000 request for a rate increase from the city of El Paso, a request the city subsequently denied. On April 21, 1998, the city council of El Paso voted to reduce the Company's rates by \$1,570,000 annually and to order a one-time cost of gas refund of \$475,000. The Company has appealed both of the council's actions to the Railroad Commission of Texas and expects a decision by the end of calendar year 1998.

On January 22, 1997, Missouri Gas Energy was notified by the MPSC of its decision to grant an \$8,847,000 annual increase to revenue effective on February 1, 1997. See *Commitments and Contingencies*.

The MPSC approved a three-year, experimental gas supply incentive plan for Missouri Gas Energy effective July 1, 1996. Under the plan, the Company and Missouri Gas Energy's customers share in certain savings below benchmark levels of gas costs achieved as a result of the Company's gas procurement activities. Likewise, if natural gas is acquired above benchmark levels, both the Company and customers share in such costs. For the year ended June 30, 1998 and 1997, the incentive plan achieved a reduction of overall gas costs of \$9,200,000 and \$10,200,000, respectively, resulting in savings to Missouri customers of \$5,100,000 and \$5,600,000, respectively. The Company recorded revenues of \$4,100,000 and \$4,600,000 in 1998 and 1997, respectively, under this plan. There can be no assurance that this or any similar plan will be approved by the MPSC for MGE after this plan expires on July 1, 1999.

Under the order of the Federal Energy Regulatory Commission, a major supplier of gas to Missouri Gas Energy is allowed recovery of certain previously unrecovered deferred gas costs with a remaining balance of \$9,200,000 at June 30, 1998. Missouri Gas Energy is allowed to recover these costs from its Missouri customers through a purchase gas adjustment mechanism which is filed with and approved by the MPSC. The receivable and liability associated with these costs have been recorded as a deferred charge and a deferred credit, respectively, on the consolidated balance sheet as of June 30, 1998 and 1997.

As a result of the January 31, 1994 acquisition of Missouri Gas Energy, the MPSC required Missouri Gas Energy to reduce rate base by \$30,000,000 to compensate Missouri rate payers for rate base reductions that were eliminated as a result of the acquisition. This is amortized over a ten-year period on a straight-line basis since the date of acquisition.

SOUTHERN UNION COMPANY AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

XV Leases

The Company leases certain facilities, equipment and office space under cancelable and noncancelable operating leases. The minimum annual rentals under operating leases for the next five years ending June 30 are as follows: 1999 -- \$5,603,000; 2000 -- \$3,961,000; 2001 -- \$3,262,000; 2002 -- \$2,837,000; 2003 -- \$1,732,000; and thereafter \$9,567,000. Rental expense was \$6,054,000, \$6,797,000 and \$8,098,000 for the years ended June 30, 1998, 1997 and 1996, respectively.

XVI Year 2000

Similar to all business entities, the Company will be impacted by the inability of computer application software programs to distinguish between the year 1900 and 2000 due to a commonly-used programming convention. Unless such programs are modified or replaced prior to 2000, calculations and interpretations based on date-based arithmetic or logical operations performed by such programs may be incorrect.

Management's plan addressing the impact of the Year 2000 issue on the Company focuses on the following areas: application systems, process control systems (embedded chips), technology infrastructure, physical infrastructure, and third party business partners and suppliers with which the Company has significant relationships. Management's analysis and review of these areas is comprised primarily of five phases: developing an inventory of hardware, software and embedded chips; assessing the degree to which each area is currently in compliance with Year 2000 requirements; performing renovations and repairs as needed to attain compliance; testing to ensure compliance; and developing a contingency plan if repair and renovation efforts are either unsuccessful or untimely.

Management has substantially completed the inventory and assessment phases regarding application systems, process control systems and technology infrastructure, and is performing renovations, repairs and testing of the former two categories. The review of physical infrastructure and business partners, gas transporters and suppliers is in the inventory stage. While the Company anticipates that any additional inventory and assessment efforts will be completed by the end of calendar year 1998, renovation, repair and testing of affected areas will continue through calendar year 1999. Costs incurred to date have primarily consisted of labor from the redeployment of existing information technology, legal and operational resources. The Company expects to spend approximately \$3 million for these Year 2000 compliance efforts. To the extent that such costs are incurred in Year 2000 compliance efforts, the Company will attempt recovery for such costs through regulatory relief.

In addition to the activities described above, the Company is currently replacing some of its financial and operating software programs with new programs that will be Year 2000 compliant. These new programs have significantly reduced the costs the Company expects to incur to become Year 2000 compliant. However, the Company has formed a contingency team to develop a work plan in the event that such programs are not fully operational by the end of calendar year 1999. The costs associated with this effort are being evaluated and cannot yet be determined. Although the Company does not presently anticipate a material business interruption as a result of the Year 2000, the worst case scenario if all of the Company's Year 2000 efforts failed, including the failure of third party providers to deliver services, could result in daily lost revenues of approximately \$3,200,000. This estimate is based on historical revenues recognized in the month of January.

XVII Commitments and Contingencies

On December 30, 1997, Southern Union settled the claims associated with the removal of hazardous substances from the site of a former coal gasification plant (Pine Street Canal Site) in Burlington, Vermont. The cost of the settlement did not have a material adverse effect on the Company's financial position, results of operations or cash flows.

Southern Union and Western Resources, Inc. entered into an Environmental Liability Agreement (Environmental Liability Agreement) at the time of the closing of the acquisition of Missouri Gas Energy. Subject to the accuracy of certain representations made by Western Resources in the Missouri Asset Purchase Agreement, the Environmental Liability Agreement provides for a tiered approach to the allocation of certain liabilities under environmental laws that

SOUTHERN UNION COMPANY AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

may exist or arise with respect to Missouri Gas Energy. The Environmental Liability Agreement contemplates Southern Union first seeking reimbursement from other potentially responsible parties, or recovery of such costs under insurance or through rates charged to customers. To the extent certain environmental liabilities were discovered by Southern Union prior to January 31, 1996, and are not so reimbursed or recovered, Southern Union will be responsible for the first \$3,000,000, if any, of out-of-pocket costs and expenses incurred to respond to and remediate any such environmental claim. Thereafter, Western Resources would share one-half of the next \$15,000,000 of any such costs and expenses, and Southern Union would be solely liable for any such costs and expenses in excess of \$18,000,000. Missouri Gas Energy owns or is otherwise associated with a number of sites where manufactured gas plants were previously operated. These plants were commonly used to supply gas service in the late 19th and early 20th centuries, in certain cases by corporate predecessors to Western Resources. By-products and residues from manufactured gas could be located at these sites and at some time in the future may require remediation by the United States Environmental Protection Agency (EPA) or delegated state regulatory authority. By virtue of notice under the Missouri Asset Purchase Agreement and its preliminary, non-invasive review, the Company became aware prior to closing of eleven such sites in the service territory of Missouri Gas Energy. Based on information reviewed thus far, it appears that not all of these sites may have been owned or operated by Western Resources or its predecessors in interest. Subsequent to the closing of the acquisition of Missouri Gas Energy, as a result of an environmental audit, the Company has discovered the existence of possibly eight additional sites in the service territory of Missouri Gas Energy. Southern Union has so informed Western Resources. The Company does not know if any of these additional sites were ever owned or operated by Western Resources or any of its predecessors in interest. Western Resources has informed the Company that it was notified in 1991 by the EPA that it was evaluating one of the sites (in St. Joseph, Missouri) for any potential threat to human health and the environment. Western Resources has also advised the Company, as of September 15, 1994, the EPA had not notified it that any further action may be required. Evaluation of the remainder of the sites by appropriate federal and state regulatory authorities may occur in the future. At the present time and based upon information available to management, the Company believes that the costs of any remediation efforts that may be required for these sites for which it may ultimately have responsibility will not exceed the aggregate amount subject to substantial sharing by Western Resources.

In addition to the various Missouri Gas Energy sites described above, the Company is investigating the possibility that the Company or predecessor companies may have been associated with Manufactured Gas Plant (MGP) sites in other of its former service territories, principally in Arizona and New Mexico, and present service territories in Texas. At the present time, the Company is aware of certain plant sites in some of these areas and is investigating those and certain other locations.

The municipal owner of a property adjacent to one of the Company's service locations has raised concerns over the continued operation of that property as a park due to its former use as a portion of an MGP site. The Texas Water Commission (TWC), in cooperation with the EPA, conducted a site inspection and preliminary assessment of this MGP site. Correspondence received from the TWC in 1989 concluded that the site "did not appear at the time of our inspection to pose an apparent threat to the public or the environment." Pending the performance of a risk assessment report, in April 1996 the city closed the park and subsequently permanently relocated the park recreational activities. Based upon the health risk evaluation conclusions contained in a risk assessment report completed in November, 1997, the city proceeded with plans to utilize the property for basketball courts and city parking. The project was completed and the renovated park was officially dedicated in a ceremony held on June 19, 1998. Based upon currently available information, Southern Union does not believe the outcome of this matter will have a material adverse effect on its financial position, results of operations or cash flows.

While the Company's evaluation of these Texas, Arizona and New Mexico MGP sites is in its preliminary stages, it is likely that some compliance costs may be identified and become subject to reasonable quantification. To the extent that such potential costs are quantified, the Company expects to provide any appropriate accruals and seek recovery for such remediation costs through all appropriate means, including insurance and regulatory relief. Although significant charges to earnings could be required prior to rate recovery, management does not believe that environmental expenditures for such MGP sites will have a material adverse effect on the Company's financial position, results of operations or cash flows.

SOUTHERN UNION COMPANY AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Pursuant to a 1989 MPSC order, Missouri Gas Energy is engaged in a major gas safety program in its service area. This program includes replacement of company- and customer-owned gas service and yard lines, the movement and resetting of meters, the replacement of cast iron mains and the replacement and cathodic protection of bare steel mains (Missouri Safety Program). In connection with this program, the MPSC issued an accounting authority order (AAO) in Case No. GO-92-234 in 1994 which authorized Missouri Gas Energy to defer depreciation expenses, property taxes and carrying costs at a rate of 10.54% on the costs incurred in the Missouri Safety Program. This AAO was consistent with those which were issued by the MPSC from 1990 through 1993 to the predecessor owner of Missouri Gas Energy. The MPSC rate order of January 22, 1997, however, retroactively reduced the carrying cost rate applied by the Company on the expenditures incurred on the Missouri Safety Program since early 1994 to an Allowance for Funds Used During Construction (AFUDC) rate of approximately 6%. The Company filed an appeal of that portion of the rate order in the Missouri State Court of Appeals, Western District. On August 18, 1998, the Missouri State Court of Appeals denied the Company's appeal resulting in a one-time non-cash write-off of \$5,942,000 of previously recorded deferred costs which was recorded as of June 30, 1998. The Company believes that the inconsistent treatment by the MPSC in subsequently changing to the AFUDC rate from the previously ordered rate of 10.54% constitutes retroactive ratemaking. Unfortunately, the decision by the Missouri State Court of Appeals failed to address certain specific language within the 1994 AAO that the Company believed prevented the MPSC from retroactively changing the carrying cost rate. Southern Union will seek a transfer of the case to the Missouri Supreme Court; however, the likelihood of transfer is uncertain.

The continuation of the Missouri Safety Program will result in significant levels of future capital expenditures. The Company estimates incurring capital expenditures of \$19,000,000 in fiscal 1999 related to this program.

On August 18, 1998, a jury in Edinburg, Texas concluded deliberations on the City of Edinburg's franchise fee lawsuit against Valero Energy Corporation (Valero) and a number of its subsidiaries, as well as former Valero subsidiary Rio Grande Valley Gas Company (RGV) and RGV's successor company, Southern Union Company. The case, based upon events that occurred between 1985-1987, centers on specific contractual language in the 1985 franchise agreement between RGV and the City of Edinburg. Southern Union purchased RGV from Valero in October 1993. The jury awarded the plaintiff damages, under several largely overlapping but mutually exclusive claims, totaling approximately \$13,000,000. The actual amount and appropriate allocation of the surviving portions of the damage awards will not be determined until further proceedings are completed, including the trial judge's decision on post-trial motions. The Company is pursuing having the jury's verdict overturned or reduced by the trial judge, and if necessary will vigorously pursue a reversal on appeal. The Company believes it will ultimately prevail and thus has not provided for any loss relative to this matter in its financial statements. Furthermore, the Company has not determined what impact, if any, this jury decision may have on other city franchises in Texas.

Southern Union and its subsidiaries are parties to other legal proceedings that management considers to be normal actions to which an enterprise of its size and nature might be subject, and not to be material to the Company's overall business or financial condition, results of operations or cash flows.

As a result of the acquisition of Missouri Gas Energy, the Company assumed certain obligations related to a 1990 settlement of a Wyoming Tight Sands anti-trust claim. To secure the refund of the settlement proceeds, the MPSC authorized the establishment of an independently administered trust to collect cash receipts under the Tight Sands settlement and repay credit-facility borrowings used for the lump sum payment. In the event the trust does not receive cash payments from the gas suppliers as provided by the Tight Sands settlement agreements, the Company is committed to pay its applicable portion of the amount owed the lender of the credit facility borrowings. Due to excess cash payments received from gas suppliers, the Company's allocable portion of the credit facility obligations have been fulfilled two years ahead of the original payment schedule. In accordance with the Wyoming Tight Sands agreement, the Company's portion of the ongoing cash payments received from the gas suppliers will be refunded to Missouri Gas Energy customers as specifically defined in the Company's Purchased Gas Adjustment tariff provisions.

The Company is committed under various agreements to purchase certain quantities of gas in the future. At June 30, 1998, the Company has purchase commitments for certain quantities of gas at variable, market-based prices. These market-based price commitments have an annual value of \$45,900,000 for Southern Union Gas and \$65,900,000

SOUTHERN UNION COMPANY AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

for Missouri Gas Energy. South Florida Natural Gas has no market-based price commitments at June 30, 1998. The Company's purchase commitments may extend over a period of several years depending upon when the required quantity is purchased. The Company has purchase gas tariffs in effect for all its utility service areas that provide for recovery of its purchase gas costs under defined methodologies.

On May 1, 1996, the Company agreed to three-year contracts with the bargaining-unit Missouri employees. Of the Company's employees represented by unions, 95% are employed by Missouri Gas Energy.

The Company had standby letters of credit outstanding of \$2,947,000 at both June 30, 1998 and 1997, which guarantee payment of various insurance premiums and state taxes.

The Company follows the provisions of an American Institute of Certified Public Accountants Statement of Position, *Environmental Remediation Liabilities*, for recognition, measurement, display and disclosure of environmental remediation liabilities.

XVIII Quarterly Operations (Unaudited)

Year Ended June 30, 1998	Quarter Ended				Total
	September 30	December 31	March 31	June 30	
Total operating revenues	\$ 74,039	\$ 221,162	\$ 265,176	\$ 108,927	\$ 669,304
Operating margin	41,597	77,328	94,676	50,123	263,724
Net operating revenues	1,405	26,530	36,940	3,792	68,667
Net earnings (loss) available for common stock ⁽¹⁾	(4,909)	9,738	16,249	(8,849)	12,229
Earnings (loss) per share -- diluted ⁽²⁾	(.18)	.35	.56	(.31)	.43

Year Ended June 30, 1997	Quarter Ended				Total
	September 30	December 31	March 31	June 30	
Total operating revenues	\$ 80,830	\$ 231,462	\$ 316,915	\$ 87,824	\$ 717,031
Operating margin	41,415	76,517	100,921	48,990	267,843
Net operating revenues	439	25,565	36,999	8,467	71,470
Net earnings (loss) available for common stock	(5,405)	9,661	17,678	(2,902)	19,032
Earnings (loss) per share -- diluted ⁽²⁾	(.20)	.35	.63	(.11)	.68

(1) During the quarter ended June 30, 1998, Missouri Gas Energy wrote off \$8,163,000 pre-tax in previously recorded regulatory assets as a result of announced rate orders and court rulings.

(2) The sum of earnings per share by quarter may not equal the net earnings per common and common share equivalents for the year due to variations in the weighted average common and common share equivalents outstanding used in computing such amounts.

SOUTHERN UNION COMPANY AND SUBSIDIARIES
FORM 10-Q
March 31 1999

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q

For the quarterly period ended

March 31, 1999

Commission File No. 1-6407

SOUTHERN UNION COMPANY

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization) :

75-0571592
(I.R.S. Employer
Identification No.)

504 Lavaca Street, Eighth Floor
Austin, Texas
(Address of principal executive offices)

78701
(Zip Code)

Registrant's telephone number, including area code: **(512) 477-5852**

Securities Registered Pursuant to Section 12(b) of the Act:

Title of each class
Common Stock, par value \$1 per share

Name of each exchange in which registered
New York Stock Exchange

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

The number of shares of the registrant's Common Stock outstanding on April 30, 1999 was 29,692,749.

SOUTHERN UNION COMPANY AND SUBSIDIARIES
FORM 10-Q
March 31, 1999
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SOUTHERN UNION COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS

	Three Months Ended March 31,	
	1999	1998
	(thousands of dollars, except shares and per share amounts)	
Operating revenues	\$ 251,863	\$ 265,176
Gas purchase costs	153,757	170,500
Operating margin	98,106	94,676
Revenue-related taxes	14,487	15,240
Net operating margin	83,619	79,436
Operating expenses:		
Operating, maintenance and general	28,655	29,143
Depreciation and amortization	10,535	9,775
Taxes, other than on income and revenues	3,782	3,578
Total operating expenses	42,972	42,496
Net operating revenues	40,647	36,940
Other income (expenses):		
Interest	(8,962)	(8,970)
Dividends on preferred securities of subsidiary trust	(2,370)	(2,370)
Other, net	(252)	1,257
Total other expenses, net	(11,584)	(10,083)
Earnings before income taxes	29,063	26,857
Federal and state income taxes	11,439	10,608
Net earnings available for common stock	\$ 17,624	\$ 16,249
Net earnings per share:		
Basic	\$.59	\$.55
Diluted	\$.57	\$.53
Weighted average shares outstanding:		
Basic	29,686,041	29,595,655
Diluted	31,071,277	30,657,152

See accompanying notes.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS

	Nine Months Ended March 31.	
	1999	1998
	(thousands of dollars, except shares and per share amounts)	
Operating revenues	\$ 503,543	\$ 560,377
Gas purchase costs	<u>292,370</u>	<u>346,775</u>
Operating margin	211,173	213,602
Revenue-related taxes	<u>27,169</u>	<u>29,873</u>
Net operating margin	184,004	183,729
 Operating expenses:		
Operating, maintenance and general	81,776	79,602
Depreciation and amortization	31,449	28,923
Taxes, other than on income and revenues	<u>10,774</u>	<u>10,331</u>
Total operating expenses	<u>123,999</u>	<u>118,856</u>
Net operating revenues	<u>60,005</u>	<u>64,873</u>
 Other income (expenses):		
Interest	(26,843)	(26,544)
Dividends on preferred securities of subsidiary trust	(7,110)	(7,110)
Other, net	<u>311</u>	<u>3,619</u>
Total other expenses, net	<u>(33,642)</u>	<u>(30,035)</u>
 Earnings before income taxes	26,363	34,838
 Federal and state income taxes	<u>10,413</u>	<u>13,761</u>
 Net earnings available for common stock	<u>\$ 15,950</u>	<u>\$ 21,077</u>
 Net earnings per share:		
Basic	<u>\$.54</u>	<u>\$.73</u>
Diluted	<u>\$.51</u>	<u>\$.71</u>
 Weighted average shares outstanding:		
Basic	<u>29,647,698</u>	<u>28,743,424</u>
Diluted	<u>31,020,308</u>	<u>29,844,444</u>

See accompanying notes.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS

	<u>Twelve Months Ended March 31,</u>	
	<u>1999</u>	<u>1998</u>
	(thousands of dollars, except shares and per share amounts)	
Operating revenues	\$ 612,469	\$ 648,200
Gas purchase costs	<u>351,174</u>	<u>385,609</u>
Operating margin	261,295	262,591
Revenue-related taxes	<u>32,183</u>	<u>35,649</u>
Net operating margin	229,112	226,942
Operating expenses:		
Operating, maintenance and general	109,701	101,910
Depreciation and amortization	40,963	37,986
Taxes, other than on income and revenues	<u>14,649</u>	<u>13,706</u>
Total operating expenses	<u>165,313</u>	<u>153,602</u>
Net operating revenues	<u>63,799</u>	<u>73,340</u>
Other income (expenses):		
Interest	(35,182)	(34,613)
Dividends on preferred securities of subsidiary trust	(9,480)	(9,480)
Write-off of regulatory assets	(8,163)	-
Other, net	<u>763</u>	<u>741</u>
Total other expenses, net	<u>(52,062)</u>	<u>(43,352)</u>
Earnings before income taxes	11,737	29,988
Federal and state income taxes	<u>4,636</u>	<u>11,814</u>
Net earnings available for common stock	<u>\$ 7,101</u>	<u>\$ 18,174</u>
Net earnings per share:		
Basic	<u>\$.24</u>	<u>\$.63</u>
Diluted	<u>\$.23</u>	<u>\$.61</u>
Weighted average shares outstanding:		
Basic	<u>29,637,869</u>	<u>28,635,171</u>
Diluted	<u>30,953,086</u>	<u>29,734,581</u>

See accompanying notes.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

ASSETS

	March 31,		June 30,
	1999	1998	1998
	(unaudited)		
	(thousands of dollars)		
Property, plant and equipment:			
Plant in service	\$ 1,093,881	\$ 1,033,862	\$ 1,057,675
Construction work in progress	<u>13,199</u>	<u>8,064</u>	<u>7,783</u>
	1,107,080	1,041,926	1,065,458
Less accumulated depreciation and amortization	<u>(376,629)</u>	<u>(351,084)</u>	<u>(355,430)</u>
	730,451	690,842	710,028
Additional purchase cost assigned to utility plant, net	<u>135,317</u>	<u>136,965</u>	<u>138,381</u>
Net property, plant and equipment	<u>865,768</u>	<u>827,807</u>	<u>848,409</u>
Current assets:			
Cash and cash equivalents	-	265	-
Accounts receivable, billed and unbilled	101,553	118,828	53,760
Inventories, principally at average cost	25,716	17,643	26,160
Prepayments and other	<u>2,179</u>	<u>1,613</u>	<u>4,747</u>
Total current assets	<u>129,448</u>	<u>138,349</u>	<u>84,667</u>
Deferred charges	90,218	103,698	94,550
Investment securities	10,000	5,000	5,000
Real estate	9,438	9,762	9,741
Other	<u>7,953</u>	<u>5,321</u>	<u>5,397</u>
Total	<u>\$ 1,112,825</u>	<u>\$ 1,089,937</u>	<u>\$ 1,047,764</u>

See accompanying notes.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET (Continued)

STOCKHOLDERS' EQUITY AND LIABILITIES

	March 31,		June 30,
	1999	1998	1998
	(unaudited)		
	(thousands of dollars)		
Common stockholders' equity:			
Common stock, \$1 par value; authorized 50,000,000 shares; issued 29,741,197 shares	\$ 29,741	\$ 18,848	\$ 28,252
Premium on capital stock	260,167	261,995	252,638
Less treasury stock, at cost	(794)	(794)	(794)
Retained earnings	23,790	25,588	16,738
Total common stockholders' equity	312,904	305,637	296,834
Company-obligated mandatorily redeemable preferred securities of subsidiary trust holding solely subordinated notes of Southern Union	100,000	100,000	100,000
Long-term debt and capital lease obligation	411,460	398,217	406,407
Total capitalization	824,364	803,854	803,241
Current liabilities:			
Long-term debt and capital lease obligation due within one year	2,033	1,367	1,777
Notes payable	18,603	17,000	1,600
Accounts payable	49,917	61,515	26,570
Federal, state and local taxes	28,448	29,890	14,017
Accrued interest	5,256	5,190	12,699
Customer deposits	18,352	17,914	17,686
Deferred gas purchase costs	14,968	2,191	12,257
Other	16,642	21,714	21,095
Total current liabilities	154,219	156,781	107,701
Deferred credits and other	71,763	71,989	74,217
Accumulated deferred income taxes	62,479	57,313	62,605
Commitments and contingencies	—	—	—
Total	\$ 1,112,825	\$ 1,089,937	\$ 1,047,764

See accompanying notes.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

	<u>Common Stock, \$1 Par Value</u>	<u>Premium on Capital Stock</u>	<u>Treasury Stock, at Cost</u> <small>(thousands of dollars)</small>	<u>Retained Earnings</u>	<u>Unrealized Holding Gain (Loss)</u>	<u>Total</u>
Balance July 1, 1997	\$ 17,171	\$ 225,252	\$ (794)	\$ 25,169	\$ 664	\$ 267,462
Net earnings	-	-	-	12,229	-	12,229
5% stock dividend	856	19,802	-	(20,658)	-	-
Three-for-two stock split	9,400	(9,400)	-	(2)	-	(2)
Issuance of stock for acquisition .	756	17,285	-	-	-	18,041
Unrealized holding gain or loss ..	-	-	-	-	(664)	(664)
Exercise of stock options	<u>69</u>	<u>(301)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(232)</u>
Balance June 30, 1998	28,252	252,638	(794)	16,738	-	296,834
Net earnings	-	-	-	15,950	-	15,950
5% stock dividend	1,411	7,483	-	(8,898)	-	(4)
Exercise of stock options	<u>78</u>	<u>46</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>124</u>
Balance March 31, 1999	<u>\$ 29,741</u>	<u>\$ 260,167</u>	<u>\$ (794)</u>	<u>\$ 23,790</u>	<u>\$ -</u>	<u>\$ 312,904</u>

See accompanying notes.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

	<u>Three Months Ended March 31,</u>	
	<u>1999</u>	<u>1998</u>
	(thousands of dollars)	
Cash flows from operating activities:		
Net earnings	\$ 17,624	\$ 16,249
Adjustments to reconcile net earnings to net cash flows from operating activities:		
Depreciation and amortization	10,535	9,775
Deferred income taxes	1,133	1,332
Provision for bad debts	1,192	2,259
Deferral and amortization of interest and other expenses	153	(574)
Other	358	259
Changes in assets and liabilities, net of acquisitions and dispositions:		
Accounts receivable, billed and unbilled	(980)	13,411
Accounts payable	1,429	(10,766)
Taxes and other liabilities	6,714	1,812
Customer deposits	(311)	394
Deferred gas purchase costs	10,554	31,155
Inventories	10,718	20,201
Other	725	3,090
Net cash flow from operating activities	<u>59,844</u>	<u>88,597</u>
Cash flows used in investing activities:		
Additions to property, plant and equipment	(15,433)	(12,653)
Acquisition of operations, net of cash received	-	7,247
Purchase of investment securities	(5,000)	-
Increase (decrease) in customer advances	(98)	567
Increase (decrease) in deferred charges and credits	(1,024)	555
Other	(233)	(793)
Net cash flows used in investing activities	<u>(21,788)</u>	<u>(5,077)</u>
Cash flows used in financing activities:		
Repayment of debt and capital lease obligation	(477)	(341)
Net payments under revolving credit facility	(31,400)	(76,800)
Decrease in cash overdrafts	(6,250)	(6,122)
Other	71	8
Net cash flows used in financing activities	<u>(38,056)</u>	<u>(83,255)</u>
Change in cash and cash equivalents	-	265
Cash and cash equivalents at beginning of period	-	-
Cash and cash equivalents at end of period	<u>\$ -</u>	<u>\$ 265</u>
 Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	<u>\$ 15,654</u>	<u>\$ 15,744</u>
Income taxes	<u>\$ 1</u>	<u>\$ 325</u>

See accompanying notes.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

	<u>Nine Months Ended March 31,</u>	
	<u>1999</u>	<u>1998</u>
	(thousands of dollars)	
Cash flows from operating activities:		
Net earnings	\$ 15,950	\$ 21,077
Adjustments to reconcile net earnings to net cash flows from operating activities:		
Depreciation and amortization	31,449	28,923
Deferred income taxes	(127)	1,071
Provision for bad debts	2,371	4,311
Deferral and amortization of interest and other expenses	517	(1,246)
Gain on sale of investment securities	—	(1,088)
Other	1,069	759
Changes in assets and liabilities, net of acquisitions and dispositions:		
Accounts receivable, billed and unbilled	(50,165)	(63,787)
Accounts payable	23,368	27,739
Taxes and other liabilities	6,989	8,511
Customer deposits	665	429
Deferred gas purchase costs	2,710	(1,374)
Inventories	445	4,157
Other	<u>1,393</u>	<u>3,177</u>
Net cash flow from operating activities	<u>36,634</u>	<u>32,659</u>
Cash flows used in investing activities:		
Additions to property, plant and equipment	(50,398)	(51,828)
Acquisition of operations, net of cash received	—	6,502
Purchase of investment securities	(5,000)	(5,000)
Proceeds from sale of investment securities	—	6,531
Net change in customer advances	1,610	2,823
Net change in deferred charges and credits	71	(3,195)
Other	<u>1,518</u>	<u>(1,296)</u>
Net cash flows used in investing activities	<u>(52,199)</u>	<u>(45,463)</u>
Cash flows from financing activities:		
Repayment of debt and capital lease obligation	(1,516)	(821)
Net borrowings under revolving credit facility	17,003	15,400
Decrease in cash overdrafts	(19)	(1,567)
Other	<u>97</u>	<u>57</u>
Net cash flows from financing activities	<u>15,565</u>	<u>13,069</u>
Change in cash and cash equivalents	—	265
Cash and cash equivalents at beginning of period	—	—
Cash and cash equivalents at end of period	<u>\$ —</u>	<u>\$ 265</u>
Supplemental disclosures of cash flow information:		
Cash paid (refunded) during the period for:		
Interest	<u>\$ 33,434</u>	<u>\$ 33,317</u>
Income taxes	<u>\$ (933)</u>	<u>\$ 2,075</u>

See accompanying notes.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

	<u>Twelve Months Ended March 31,</u>	
	<u>1999</u>	<u>1998</u>
	(thousands of dollars)	
Cash flows from operating activities:		
Net earnings	\$ 7,101	\$ 18,174
Adjustments to reconcile net earnings to net cash flows from operating activities:		
Depreciation and amortization	40,963	37,986
Deferred income taxes	5,165	2,359
Provision for bad debts	3,521	5,631
Deferral and amortization of interest and other expenses	92	(694)
Write-off of regulatory assets	8,163	—
Gain on sale of investment securities	—	(1,088)
Other	1,760	1,139
Changes in assets and liabilities, net of acquisitions and dispositions:		
Accounts receivable, billed and unbilled	13,754	(6,409)
Accounts payable	(11,437)	7,683
Taxes and other liabilities	(1,376)	2,332
Customer deposits	437	104
Deferred gas purchase costs	12,777	8,802
Inventories	(8,073)	(3,286)
Other	(615)	2,526
Net cash flow from operating activities	<u>72,232</u>	<u>75,259</u>
Cash flows used in investing activities:		
Additions to property, plant and equipment	(75,588)	(73,738)
Acquisition of operations, net of cash received	—	5,803
Purchase of investment securities	(5,000)	(5,000)
Proceeds from sale of investment securities	—	9,547
Increase in customer advances	2,349	3,537
Deferred charges and credits	1,480	(10,050)
Proceeds from sale of distribution and transmission properties	—	1,130
Other	4,389	(2,430)
Net cash flows used in investing activities	<u>(72,370)</u>	<u>(71,201)</u>
Cash flows used in financing activities:		
Repayment of debt and capital lease obligation	(2,004)	(1,009)
Net borrowings (payments) under revolving credit facility	1,603	(3,800)
Increase in cash overdraft	603	—
Other	(329)	117
Net cash flows used in financing activities	<u>(127)</u>	<u>(4,692)</u>
Change in cash and cash equivalents	(265)	(634)
Cash and cash equivalents at beginning of period	265	899
Cash and cash equivalents at end of period	<u>\$ —</u>	<u>\$ 265</u>
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	\$ 34,114	\$ 33,496
Income taxes	<u>\$ 1,503</u>	<u>\$ 5,845</u>

See accompanying notes.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FINANCIAL STATEMENTS

The interim financial statements are unaudited but, in the opinion of management, reflect all adjustments (including both normal recurring as well as any non-recurring) necessary for a fair presentation of the results of operations for such periods. Because of the seasonal nature of the Company's operations, the results of operations for any interim period are not necessarily indicative of results for the full year.

These financial statements should be read in conjunction with the financial statements and notes thereto contained in Southern Union Company's (*Southern Union* and, together with its wholly-owned subsidiaries, the *Company*) Annual Report on Form 10-K for the fiscal year ended June 30, 1998. Certain prior period amounts have been reclassified to conform with the current period presentation.

NEW ACCOUNTING PRONOUNCEMENT NOT YET ADOPTED

In June 1998, the Financial Accounting Standards Board issued *Accounting for Derivative Instruments and Hedging Activities*, which is required to be adopted in years beginning after June 15, 1999. The Statement permits early adoption as of the beginning of any fiscal quarter after its issuance. The Statement will require the Company to recognize all derivatives on the balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through income. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value will be immediately recognized in earnings. The Company has not yet determined what the effect of this statement will have on the earnings and financial position of the Company.

ACQUISITION ACTIVITIES

Southwest Gas Corporation On February 1, 1999, Southern Union submitted a proposal to the Board of Directors of Southwest Gas Corporation (Southwest Gas) to acquire all of Southwest Gas' outstanding common stock for \$32.00 per share. Southwest Gas then had a pending merger agreement with ONEOK, Inc. ("ONEOK") at \$28.50 per share. On February 22, 1999, Southern Union and Southwest Gas both publicly announced Southern Union's proposal, after the Southwest Gas Board of Directors determined that Southern Union's proposal was a Superior Proposal (as defined in the Southwest Gas merger agreement with ONEOK). On April 25, 1999, Southwest Gas' Board of Directors rejected Southern Union's \$32.00 per share offer and accepted an amended offer of \$30.00 per share from ONEOK. On April 27, 1999, Southern Union increased its offer to \$33.50 per share and agreed to pay interest which, together with dividends, would provide Southwest Gas shareholders with a 6% annual rate of return on its \$33.50 offer, commencing February 15, 2000, until closing. Southern Union's revised proposal has also been rejected by the Southwest Gas Board of Directors. Presently, Southern Union, Southwest Gas and ONEOK are parties to litigation to determine the scope of Southern Union's permitted activities with respect to its effort to acquire Southwest Gas securities. In one such proceeding brought by ONEOK, the Company is the subject of a preliminary injunction with respect to its compliance with the standstill provisions of its February 21, 1999 confidentiality letter agreement with Southwest Gas. Southern Union intends to appeal that decision and to continue to evaluate its legal alternatives with respect to the acquisition of Southwest Gas securities and related proceedings.

Atlantic Utilities Effective December 31, 1997, the Company acquired Atlantic Utilities Corporation and Subsidiaries (Atlantic) for 755,650 pre-split and pre-stock dividend shares of common stock valued at \$18,041,000 and cash of \$4,436,000. Atlantic is operated as South Florida Natural Gas, a natural gas division of Southern Union, and Atlantic Gas Corporation, a propane subsidiary of the Company. Atlantic's results of operations have been included in the Company's statements of consolidated operations and cash flows since January 1, 1998. On the date of acquisition, Atlantic had \$11,683,000 of cash and cash equivalents. The acquisition was accounted for using the purchase method. The additional purchase cost assigned to utility plant of approximately \$10,000,000 reflects the excess of the purchase

SOUTHERN UNION COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

price over the historical book carrying value of the net assets acquired. The additional purchase cost is amortized on a straight-line basis over forty years.

WRITE-OFF OF REGULATORY ASSETS

Pursuant to a 1989 Missouri Public Service Commission (MPSC) order, Missouri Gas Energy (MGE) is engaged in a major gas safety program. In connection with this program, the MPSC issued an accounting authority order in 1994 which authorized MGE to defer carrying costs at a rate of 10.54%. The MPSC rate order of January 22, 1997, however, retroactively reduced the 10.54% carrying cost rate used since early 1994 to an Allowance for Funds Used During Construction (AFUDC) rate of approximately 6%. The Company filed an appeal of this portion of the rate order in the Missouri State Court of Appeals, Western District, and on August 18, 1998 was notified that the appeal was denied. This resulted in a pre-tax non-cash charge of \$5,942,000 of previously deferred costs as of June 30, 1998. See *Contingencies*.

On August 21, 1998, MGE was notified by the MPSC of its decision to grant a \$13,300,000 rate increase but disallowed certain previously recorded deferred costs, requiring an additional pre-tax non-cash write-off of \$2,221,000. Though the Company will receive a rehearing on portions of these disallowances, generally accepted accounting principles required the Company to record this charge to earnings, which Southern Union did as of June 30, 1998. See *Utility Regulation and Rates*.

EARNINGS PER SHARE

Average shares outstanding for basic earnings per share were 29,686,041 and 29,595,655 for the three-month period ended March 31, 1999 and 1998, respectively, 29,647,698 and 28,743,424 for the nine-month period ended March 31, 1999 and 1998, respectively, and 29,637,869 and 28,635,171 for the twelve-month period ended March 31, 1999 and 1998, respectively. Diluted earnings per share includes average shares outstanding as well as common stock equivalents from stock options and warrants. During the three-, nine- and twelve-month periods ended March 31, 1999 and 1998, no adjustments were required in net earnings available for common stock for the earnings per share calculations. Common stock equivalents were 1,385,236 and 1,061,497 for the three-month period ended March 31, 1999 and 1998, respectively, 1,372,610 and 1,101,020 for the nine-month period ended March 31, 1999 and 1998, respectively, and 1,315,217 and 1,099,410 for the twelve-month period ended March 31, 1999 and 1998, respectively.

INVESTMENT SECURITIES

At March 31, 1999, all securities owned by the Company are accounted for under the cost method. These securities consist of preferred stock in a non-public company. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the Consolidated Statement of Operations when incurred, and dividends are recognized as income when received.

PREFERRED SECURITIES OF SUBSIDIARY TRUST

On May 17, 1995, Southern Union Financing I (Subsidiary Trust), a consolidated wholly-owned subsidiary of Southern Union, issued \$100,000,000 of 9.48% Trust Originated Preferred Securities (Preferred Securities). In connection with the Subsidiary Trust's issuance of the Preferred Securities and the related purchase by Southern Union of all of the Subsidiary Trust's common securities (Common Securities), Southern Union issued to the Subsidiary Trust \$103,092,800 principal amount of its 9.48% Subordinated Deferrable Interest Notes, due 2025 (Subordinated Notes). The sole assets of the Subsidiary Trust are the Subordinated Notes. The interest and other payment dates on the Subordinated Notes correspond to the distribution and other payment dates on the Preferred Securities and the Common Securities. Under certain circumstances, the Subordinated Notes may be distributed to holders of the Preferred Securities and holders of the Common Securities in liquidation of the Subsidiary Trust. The Subordinated

SOUTHERN UNION COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Notes are redeemable at the option of the Company on or after May 17, 2000, at a redemption price of \$25 per Subordinated Note plus accrued and unpaid interest. The Preferred Securities and the Common Securities will be redeemed on a pro rata basis to the same extent as the Subordinated Notes are repaid, at \$25 per Preferred Security and Common Security plus accumulated and unpaid distributions. Southern Union's obligations under the Subordinated Notes and related agreements, taken together, constitute a full and unconditional guarantee by Southern Union of payments due on the Preferred Securities. As of March 31, 1999 and 1998, 4,000,000 shares of Preferred Securities were outstanding.

DEBT AND CAPITAL LEASE

	March 31, 1999	June 30, 1998
	(thousands of dollars)	
7.60% Senior Notes due 2024	\$ 384,515	\$ 384,515
Other	28,978	23,669
Total debt and capital lease	413,493	408,184
Less current portion	(2,033)	(1,777)
Total long-term debt and capital lease	\$ 411,460	\$ 406,407

The Company has availability under two revolving credit facilities (the "Revolving Credit Facilities") underwritten by a syndicate of banks. Of the Revolving Credit Facilities, \$40,000,000 is a short-term facility which expires June 30, 1999, while \$60,000,000 is a long-term facility which expires June 30, 2001. The Company has additional availability under uncommitted line of credit facilities (Uncommitted Facilities) with various banks. Covenants under the Revolving Credit Facilities allow for up to \$35,000,000 of borrowings under Uncommitted Facilities at any one time. Borrowings under the facilities are available for Southern Union's working capital, letter of credit requirements and other general corporate purposes. Amounts outstanding under these facilities at March 31, 1999 and April 30, 1999 were \$18,603,000 and \$3,000, respectively.

Capital Lease The Company completed the installation of an Automated Meter Reading (AMR) system at MGE during the first quarter of fiscal year 1999. The installation of the AMR system involved an investment of approximately \$30,000,000 which is accounted for as a capital lease obligation. As of March 31, 1999, the capital lease obligation outstanding was \$27,324,000.

UTILITY REGULATION AND RATES

Under the order of the Federal Energy Regulatory Commission, a major supplier of gas to MGE is allowed recovery of certain unrecovered deferred gas costs with a remaining balance of \$1,175,000 at March 31, 1999. MGE is allowed to recover these costs from its customers through a purchase gas adjustment mechanism approved by the MPSC. The receivable and liability associated with these costs have been recorded as a deferred charge and a deferred credit, respectively, on the consolidated balance sheet as of March 31, 1999 and 1998.

On May 21, 1998, Southern Union Gas filed with the Railroad Commission of Texas (Commission) an appeal of the city of El Paso's actions to reduce the Company's rates and require a one-time cost of gas refund. The Company requested a \$1,964,000 base rate increase and a finding that no cost of gas refund was warranted. On December 21, 1998, the Commission issued its order implementing an \$884,000 one-time cost of gas refund and a \$99,000 base rate reduction.

On August 21, 1998, MGE was notified by the MPSC of its decision to grant a \$13,300,000 rate increase which also disallowed certain previously recorded deferred costs, in which MGE requested a rehearing on significant portions of these disallowances. On December 8, 1998, the MPSC denied rehearing requests made by all parties other than MGE and granted a portion of MGE's rehearing request. The MPSC will conduct further proceedings to take additional

SOUTHERN UNION COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

evidence on those matters for which it granted MGE a rehearing. If the MPSC adopts MGE's positions on rehearing, then MGE would be authorized an additional base revenue increase in the amount of approximately \$2,200,000 (from the \$13,300,000 initially authorized in its August 21, 1998 order to \$15,500,000). The MPSC's orders may be subject to judicial review and although certain parties may argue for a reduction in MGE's authorized base revenue increase on judicial review, MGE expects such arguments to be unsuccessful.

STOCK DIVIDEND

On December 9, 1998, Southern Union distributed its annual 5% common stock dividend to stockholders of record on November 23, 1998. A portion of the 5% stock dividend was characterized as a distribution of capital due to the level of the Company's retained earnings available for distribution as of the declaration date. Unless otherwise stated, all per share data included in the accompanying consolidated financial statements and in these Notes to Consolidated Financial Statements has been restated to give effect to the stock dividend.

CONTINGENCIES

Southern Union and Western Resources entered into an Environmental Liability Agreement (Environmental Liability Agreement) at the closing of the Missouri Acquisition. Subject to the accuracy of certain representations made by Western Resources in the Missouri Asset Purchase Agreement, the Environmental Liability Agreement provides for a tiered approach to the allocation of substantially all liabilities under environmental laws that may exist or arise with respect to MGE. At the present time and based upon information available to management, the Company believes that the costs of any remediation efforts that may be required for these sites for which it may ultimately have responsibility will not exceed the aggregate amount subject to substantial sharing by Western Resources.

In addition to the various MGE sites described above, the Company is investigating the possibility that the Company or predecessor companies may have been associated with Manufactured Gas Plant (MGP) sites in other of its former service territories, principally in Arizona and New Mexico, and present service territories in Texas. At the present time, the Company is aware of certain plant sites in some of these areas and is investigating those and certain other locations.

While the Company's evaluation of these Texas, Arizona and New Mexico MGP sites is in its preliminary stages, it is likely that some compliance costs may be identified and become subject to reasonable quantification. To the extent that such potential costs are quantified, the Company expects to provide any appropriate accruals and seek recovery for such remediation costs through all appropriate means, including insurance and regulatory relief. Although significant charges to earnings could be required prior to rate recovery, management does not believe that environmental expenditures for such MGP sites will have a material adverse effect on the Company's financial position, results of operations or cash flows.

As previously disclosed in the Company's 1998 Annual Report on Form 10-K, on August 18, 1998, the Missouri State Court of Appeals denied the Company's appeal of the MPSC January 22, 1997 rate order which retroactively reduced the carrying cost rate applied by the Company on the expenditures incurred on the Missouri Safety Program since early 1994 resulting in a one-time non-cash write-off of \$5,942,000 of previously recorded deferred costs which was recorded in fiscal year 1998. Southern Union sought a transfer of the case to the Missouri Supreme Court which was denied on November 24, 1998.

In August 1998, a jury in Edinburg, Texas concluded deliberations on the City of Edinburg's franchise fee lawsuit against PG&E Gas Transmission, Texas Corporation (formerly Valero Energy Corporation (Valero)) and a number of its subsidiaries, as well as former Valero subsidiary Rio Grande Valley Gas Company (RGV) and RGV's successor company, Southern Union Company. The case, based upon events that occurred between 1985-1987, centers on specific contractual language in the 1985 franchise agreement between RGV and the City of Edinburg. Southern Union purchased RGV from Valero in October 1993. The jury awarded the plaintiff damages, against all defendants under

SOUTHERN UNION COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

several largely overlapping but mutually exclusive claims, totaling approximately \$13,000,000. The trial judge subsequently reduced the award to approximately \$700,000 against Southern Union and \$7,800,000 against Valero and Southern Union together. The Company is pursuing reversal on appeal. The Company believes it will ultimately prevail and thus has not provided for any loss relative to this matter in its financial statements. Furthermore, the Company has not determined what impact, if any, this jury decision may have on other city franchises in Texas.

Southern Union and its subsidiaries are parties to other legal proceedings that management considers to be normal actions to which an enterprise of its size and nature might be subject, and not to be material to the Company's overall business or financial condition, results of operations or cash flows.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The Company's principal line of business is the distribution of natural gas as a public utility through Southern Union Gas, Missouri Gas Energy (MGE), and Atlantic Utilities, doing business as South Florida Natural Gas (SFNG), each of which is a division of the Company. In addition, subsidiaries of Southern Union have been established to support and expand natural gas sales and to capitalize on the Company's gas energy expertise. These subsidiaries operate natural gas pipeline systems, market natural gas to end-users and distribute propane. By providing "one-stop shopping," the Company can serve its various customers' specific energy needs, which encompass substantially all of the natural gas distribution and sales businesses from natural gas sales to specialized energy consulting services. Certain subsidiaries own or hold interests in real estate and other assets, which are primarily used in the Company's utility business.

Several of these business activities are subject to regulation by federal, state or local authorities where the Company operates. Thus, the Company's financial condition and results of operations have been and will continue to be dependent upon the receipt of adequate and timely adjustments in rates. In addition, the Company's business is affected by seasonal weather impacts, competitive factors within the energy industry and economic development and residential growth in its service areas.

RESULTS OF OPERATIONS

Three Months Ended March 31, 1999 and 1998

The Company recorded net earnings available for common stock of \$17,624,000 for the three-month period ended March 31, 1999 compared with net earnings of \$16,249,000 for the same period in 1998. Earnings per diluted share, based on weighted average common and common share equivalents outstanding during the period were \$.57 in 1999 compared with earnings per diluted share of \$.53 in 1998.

Operating revenues were \$251,863,000 for the three-month period ended March 31, 1999, compared with operating revenues of \$265,176,000 in 1998. Gas purchase costs for the three-month period ended March 31, 1999 were \$153,757,000, compared with \$170,500,000 in 1998. The Company's operating revenues are affected by the level of sales volumes and by the pass-through of increases or decreases in the Company's gas purchase costs through its purchased gas adjustment clauses. Additionally, revenues are affected by increases or decreases in gross receipts taxes (revenue-related taxes) which are levied on sales revenue as collected from customers and remitted to the various taxing authorities. The decrease in both operating revenues and gas purchase costs between periods was primarily the result of a 7% decrease in the average cost of gas from \$3.59 per Mcf in 1998 to \$3.33 per Mcf in 1999. Changes in the average cost of gas result from seasonal impacts on demands for natural gas and the ensuing competitive pricing within the industry. Additionally, operating revenues and gas purchase costs were affected by a 2% decrease in gas sales volume to 46,068 MMcf in 1999 from 47,077 MMcf in 1998. The decrease in sales volumes was due to significantly warmer weather primarily in the Texas service areas during the three-month period ended March 31, 1999. Slightly offsetting these factors was a \$13,300,000 annual increase to revenues in the Missouri service territories granted by the Missouri Public Service Commission (MPSC) effective as of September 2, 1998. The impact from this rate order was marginal as it is earned volumetrically and therefore was affected by the unusually warm weather.

Weather for MGE's service territories was 87% of a 30-year measure for the three-month period ended March 31, 1999, compared with 85% in 1998. Southern Union Gas service territories experienced weather that was 65% of a 30-year measure in 1999, compared with 84% in 1998. About half of the customers served by Southern Union Gas are weather normalized.

Net operating margin (operating margin less revenue-related taxes) increased \$4,183,000 to \$83,619,000 for the three-month period ended March 31, 1999 compared with the same period in 1998. Net operating margin increased primarily due to a \$13,300,000 annual increase to revenues in the Missouri service territories granted by the MPSC effective as of September 2, 1998.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Operating expenses, which include operating, maintenance and general expenses, depreciation and amortization and taxes, other than on income and revenues, were \$42,972,000 for the three-month period ended March 31, 1999, an increase of \$476,000, compared with \$42,496,000 in 1998. The increase is primarily a result of an increase in depreciation and amortization and an increase in property taxes pursuant to the September 2, 1998 Missouri rate order, discussed above, which included certain costs into rate base that had been previously deferred.

Interest expense was \$8,962,000 for the three-month period ended March 31, 1999, compared with \$8,970,000 in 1998. See "Debt and Capital Lease" in the Notes to the Consolidated Financial Statements included herein.

Other expense of \$252,000 for the three-month period ended March 31, 1999 primarily consisted of net expense of \$153,000 related to the amortization and current deferral of interest and other expenses associated with the MGE Safety Program. Other income of \$1,257,000 for the three-month period ended March 31, 1998 primarily consisted of \$526,000 related to the deferral of interest and other expenses associated with the MGE Safety Program and net rental income from Lavaca Realty Company (Lavaca Realty), the Company's real estate subsidiary, of \$269,000.

The Company's consolidated federal and state effective income tax rate was 39% for the three-month periods ended March 31, 1999 and 1998.

Nine Months Ended March 31, 1999 and 1998

The Company recorded net earnings available for common stock of \$15,950,000 for the nine-month period ended March 31, 1999, compared with net earnings of \$21,077,000 for the same period in 1998. Earnings per diluted share, based on weighted average common and common share equivalents outstanding during the period, were \$.51 in 1999 compared with earnings per diluted share of \$.71 in 1998. Weighted average common and common share equivalents increased 4% during 1999 compared with 1998 due to the issuance of 755,650 pre-split and pre-stock dividend shares of the Company's common stock on December 31, 1997 in connection with the acquisition of Atlantic Utilities Corporation and Subsidiaries (Atlantic Utilities) in Florida.

Operating revenues were \$503,543,000 for the nine-month period ended March 31, 1999, compared with operating revenues of \$560,377,000 in 1998. Gas purchase costs for the nine-month period ended March 31, 1999 were \$292,370,000 compared with \$346,775,000 in 1998. The decrease in both operating revenues and gas purchase costs between periods was the result of an 8% decrease in the average cost of gas from \$3.56 in 1998 to \$3.26 per Mcf in 1999, due to changes in average spot market gas prices. Additionally, operating revenues and gas purchase costs were affected by an 8% decrease in gas sales volume to 88,940 MMcf in 1999 from 96,672 MMcf in 1998. The decrease in sales volumes was due to significantly warmer weather in the Missouri and Texas service areas during the nine-month period ended March 31, 1999. The decrease in operating revenues was partially offset by a \$13,300,000 annual increase to revenues granted to MGE, effective as of September 2, 1998. The impact from this rate order was marginal as it is earned volumetrically and, therefore, was affected by the unusually warm weather.

MGE's service territories experienced weather which was 84% of a 30-year measure for the nine months ended March 31, 1999 compared with 91% in 1998. Weather for Southern Union Gas service territories for the nine-month period ended March 31, 1999 was 73% of a 30-year measure compared with 97% in 1998.

Net operating margin increased \$275,000 to \$184,004,000 for the nine-month period ended March 31, 1999 compared with the same period in 1998. Net operating margin increased primarily due to a \$13,300,000 annual increase to revenues in the Missouri service territories granted by the MPSC effective as of September 2, 1998 which was partially offset by reduced gas sales volumes as a result of significantly warmer weather, previously discussed.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Operating expenses were \$123,999,000 for the nine-month period ended March 31, 1999, an increase of \$5,143,000, compared with \$118,856,000 in 1998. The increase is primarily the result of an increase in depreciation and amortization and property taxes as a result of including certain costs into rate base that had been previously deferred. Also contributing to the increase was the inclusion of Atlantic Utilities, which was acquired effective December 31, 1997, as well as increased legal fees and assessments associated with certain claims and litigation.

Interest expense was \$26,843,000 for the nine-month period ended March 31, 1999, compared with \$26,544,000 in 1998. The increase is primarily due to the addition of a capital lease obligation for the installation of an Automated Meter Reading (AMR) system at MGE. See "Debt and Capital Lease" in the Notes to the Consolidated Financial Statements included herein.

Other income for the nine-month period ended March 31, 1999 was \$311,000 compared with \$3,619,000 in 1998. Other income for the nine-month period ended March 31, 1999 included net rental income from Lavaca Realty of \$935,000, which was partially offset by net expense of \$517,000 related to the amortization and current deferral of interest and other expenses associated with the MGE Safety Program. Other income for the nine-month period ended March 31, 1998 included \$1,246,000 related to the deferral of interest and other expenses associated with the MGE Safety Program, realized gains on the sale of investment securities of \$1,088,000 and net rental income from Lavaca Realty of \$756,000.

The Company's consolidated federal and state effective income tax rate was and 39% for the nine-month periods ended March 31, 1999 and 1998, respectively.

Twelve Months Ended March 31, 1999 and 1998

The Company recorded net earnings available for common stock of \$7,101,000 for the twelve-month period ended March 31, 1999 compared with net earnings of \$18,174,000 in 1998. Earnings per diluted share based on weighted average common and common share equivalents outstanding during the period were \$.23 in 1999 compared with earnings per diluted share of \$.61 in 1998. Weighted average common and common share equivalents increased 4% during the twelve-month period ended March 31, 1999 compared with 1998 due to the issuance of common stock in the acquisition of Atlantic Utilities, previously discussed.

During fiscal year 1998, the Company was impacted by pre-tax non-cash write-offs totaling \$8,163,000 of previously recorded regulatory assets. On August 18, 1998, the Missouri Court of Appeals denied the previously disclosed appeal by the Company of the MPSC's January 1997 Rate Order granted to MGE. Because of this decision, the Company recorded a one-time non-cash write-off of \$5,942,000 of deferred costs recorded since 1994. On August 21, 1998, the MPSC also granted MGE a rate increase which, among other things, disallowed certain previously recorded deferred costs requiring an additional pre-tax non-cash write-off of \$2,221,000. See "Write-Off of Regulatory Assets" and "Contingencies" in the Notes to the Consolidated Financial Statements included herein.

Operating revenues were \$612,469,000 for the twelve-month period ended March 31, 1999, compared with operating revenues of \$648,200,000 in 1998. Gas purchase costs for the twelve-month period ended March 31, 1999 were \$351,174,000, compared with gas purchase costs of \$385,609,000 in 1998. The decrease in both operating revenues and gas purchase costs between periods was primarily the result of a 5% decrease in gas sales volume to 108,113 MMcf in 1999 from 114,063 MMcf in 1998. The decrease in sales volumes was due to significantly warmer weather in the Missouri and Texas service areas during the twelve-month period ended March 31, 1999. Additionally, operating revenues and gas purchase costs were affected by a 4% decrease in the average cost of gas from \$3.35 per Mcf in 1998 to \$3.23 per Mcf in 1999, due to changes in average spot market gas prices. The decrease in operating revenues was partially offset by a \$13,300,000 annual increase to revenues granted to MGE, effective as of September 2, 1998.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The impact from this rate increase was marginal as it is earned volumetrically and, therefore, was also affected by the unusually warm weather.

MGE's service territories experienced weather that was 84% of the 30-year measure for the twelve-month period ended March 31, 1999 compared with 95% in 1998. Weather for Southern Union Gas service territories for the twelve-month period ended March 31, 1999 was 75% of a 30-year measure compared with 103% in 1998.

Net operating margin increased \$2,170,000 to \$229,112,000 for the twelve-month period ended March 31, 1999 compared with the same period in 1998. Net operating margin increased primarily due to a \$13,300,000 annual increase to revenues in the Missouri service territories granted by the MPSC effective as of September 2, 1998 which was partially offset by reduced gas sales volumes as a result of significantly warmer weather as previously discussed.

Operating expenses were \$165,313,000 for the twelve-month period ended March 31, 1999, an increase of \$11,711,000, compared with operating expenses of \$153,602,000 in 1998. The increase is a result of increased legal fees and expenses associated with various claims and litigation, increased employee benefits costs, increased general and administrative costs, the inclusion of operating expenses for Atlantic Utilities, acquired effective December 31, 1997, as well as acquired and expanded propane activities. Also contributing to the increase was an increase in depreciation and amortization and property taxes as a result of including certain costs into rate base that had been previously deferred.

Interest expense was \$35,182,000 for the twelve-month period ended March 31, 1999, compared with \$34,613,000 in 1998. The increase is primarily due to the addition of a capital lease obligation for the installation of an AMR system at MGE, previously discussed. See "Debt and Capital Lease" in the Notes to the Consolidated Financial Statements included herein.

Other income for the twelve-month period ended March 31, 1999 was \$763,000 compared with \$741,000 in 1998. Other income for the twelve-month period ended March 31, 1999 included \$1,298,000 in net rental income from Lavaca Realty. Other income for the twelve-month period ended March 31, 1998 included \$1,088,000 in realized gains on the sale of investment securities, net rental income from Lavaca Realty of \$1,017,000 and \$694,000 related to the deferral of interest and other expenses associated with the MGE Safety Program. This was partially offset by \$2,150,000 for the settlement of certain billing errors at MGE.

The Company's consolidated federal and state effective income tax rate was 39% for the twelve-month periods ended March 31, 1999 and 1998.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following table sets forth certain information regarding the Company's gas utility operations for the three- and twelve-month periods ended March 31, 1999 and 1998:

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	1999	1998	1999	1998
Average number of gas sales customers served:				
Residential	906,268	896,600	892,196	877,103
Commercial	91,432	91,152	88,308	86,941
Industrial and irrigation	572	560	569	569
Pipeline and marketing	237	226	233	223
Public authorities and other	2,887	2,841	2,841	2,743
Total average customers served	<u>1,001,396</u>	<u>991,379</u>	<u>984,147</u>	<u>967,579</u>
Gas sales in millions of cubic feet (MMcf):				
Residential	30,156	31,393	57,438	64,833
Commercial	12,415	12,820	25,624	28,277
Industrial and irrigation	394	504	1,520	1,658
Pipeline and marketing	5,807	5,113	20,338	16,707
Public authorities and other	1,076	1,280	2,322	2,714
Gas sales billed	49,848	51,110	107,242	114,189
Net change in unbilled gas sales	(3,780)	(4,033)	871	(126)
Total gas sales	<u>46,068</u>	<u>47,077</u>	<u>108,113</u>	<u>114,063</u>
Gas sales revenues (thousands of dollars):				
Residential	\$ 172,746	\$ 182,328	\$ 368,947	\$ 398,140
Commercial	68,446	72,750	141,510	153,824
Industrial and irrigation	1,913	2,484	6,800	7,736
Pipeline and marketing	13,232	12,025	47,714	39,484
Public authorities and other	3,832	4,918	8,818	11,160
Gas sales revenues billed	260,269	274,505	573,789	610,344
Net change in unbilled gas sales revenues	(19,390)	(21,417)	4,261	1,212
Total gas sales revenues	<u>\$ 240,879</u>	<u>\$ 253,088</u>	<u>\$ 578,050</u>	<u>\$ 611,556</u>
Gas sales margin (thousands of dollars)	<u>\$ 73,169</u>	<u>\$ 68,801</u>	<u>\$ 197,143</u>	<u>\$ 193,469</u>
Gas sales revenue per thousand cubic feet (Mcf) billed:				
Residential	\$ 5.728	\$ 5.808	\$ 6.423	\$ 6.141
Commercial	5.513	5.675	5.523	5.440
Industrial and irrigation	4.858	4.929	4.473	4.666
Pipeline and marketing	2.279	2.352	2.346	2.363
Public authorities and other	3.654	3.842	3.798	4.112
Weather:				
Degree days:				
Southern Union Gas service territories	800	1,055	1,609	2,131
Missouri Gas Energy service territories	2,429	2,388	4,418	4,882
Percent of normal, based on 30-year measure:				
Southern Union Gas service territories	65%	84%	75%	103%
Missouri Gas Energy service territories	87%	85%	84%	95%
Gas transported in millions of cubic feet (MMcf)	16,700	15,231	55,314	63,446
Gas transportation revenues (thousands of dollars)	\$ 6,351	\$ 6,221	\$ 19,963	\$ 20,066

The above information does not include the Company's 43% equity ownership in a natural gas distribution company serving 17,800 customers in Piedras Negras, Mexico.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FINANCIAL CONDITION

The Company's gas utility operations are seasonal in nature with a significant percentage of the annual revenues and earnings occurring in the traditional heating-load months. This seasonality results in a high level of cash flow needs during the peak winter heating season months, resulting from the required payments to natural gas suppliers in advance of the receipt of cash payments from the Company's customers. The Company has historically used internally generated funds and its revolving loan and credit facilities to provide funding for its seasonal working capital, continuing construction and maintenance programs and operational requirements.

The principal source of funds during the three-month period ended March 31, 1999 included \$59,844,000 in cash flow from operations. This source provided funds for additions to property, plant and equipment of \$15,433,000, \$5,000,000 for the purchase of investment securities and \$31,400,000 in net repayments under the Company's revolving credit facility.

The principal sources of funds during the nine-month period ended March 31, 1999 included \$36,634,000 in cash flow from operations and \$17,003,000 from the Company's revolving and uncommitted credit facilities. These sources provided funds for additions to property, plant and equipment of \$50,398,000 and \$5,000,000 for the purchase of investment securities.

The effective interest rate under the Company's current debt structure is 7.67% (including interest and the amortization of debt issuance costs and redemption premiums on refinanced debt).

The Company has availability under two revolving credit facilities (the "Revolving Credit Facilities") underwritten by a syndicate of banks. Of the Revolving Credit Facilities, \$40,000,000 is a short-term facility which expires June 30, 1999, while \$60,000,000 is a long-term facility which expires June 30, 2001. The Company has additional availability under uncommitted line of credit facilities (Uncommitted Facilities) with various banks. Covenants under the Revolving Credit Facilities allow for up to \$35,000,000 of borrowings under Uncommitted Facilities at any one time. Borrowings under the facilities are available for Southern Union's working capital, letter of credit requirements and other general corporate purposes. Amounts outstanding under these facilities at March 31, 1999 and April 30, 1999 were \$18,603,000 and \$3,000, respectively.

YEAR 2000

Similar to all business entities, the Company will be impacted by the inability of computer application software programs to distinguish between the year 1900 and 2000 due to a commonly-used programming convention. Unless such programs are modified or replaced prior to 2000, calculations and interpretations based on date-based arithmetic or logical operations performed by such programs may be incorrect.

Management's plan addressing the impact of the Year 2000 issue on the Company focuses on the following areas: application systems, process control systems (embedded chips), technology infrastructure, physical infrastructure, and third party business partners and suppliers with which the Company has significant relationships. Management's analysis and review of these areas is comprised primarily of five phases: developing an inventory of hardware, software and embedded chips; assessing the degree to which each area is currently Year 2000 ready; performing renovations and repairs as needed to attain Year 2000 readiness; testing to ensure Year 2000 readiness; and developing a contingency plan if repair and renovation efforts are either unsuccessful or untimely.

Management has completed the inventory phase and has substantially completed the assessment phase regarding application systems, process control systems and technology infrastructure, and is performing renovations, repairs and testing in each of these categories. The review of physical infrastructure and critical business partners, gas transporters

SOUTHERN UNION COMPANY AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

and suppliers is in the assessment stage. The Company's inventory efforts were completed prior to the end of calendar year 1998. The Company's assessment, renovation and repair efforts are substantially complete. The testing of affected areas will continue through calendar year 1999. Costs incurred to date have primarily consisted of labor from the redeployment of existing information technology, legal and operational resources. The Company expects to spend approximately \$6,500,000 for these Year 2000 readiness efforts. Included in this estimate are equipment leasing expenses that will be incurred over the life of the equipment. To the extent that such costs are incurred in Year 2000 readiness efforts, the Company will attempt recovery for such costs through regulatory relief.

During the past several years the Company has replaced most of its financial and operating software programs. In addition, the Company is currently in the process of replacing those remaining programs to be able to be Year 2000 ready. These new programs have significantly reduced the costs the Company expects to incur to become Year 2000 ready. Additionally, the Company has formed a planning team to develop a contingency plan in the event that supplier or internal operational failures do occur. The costs associated with this effort are being evaluated and cannot yet be determined. Although the Company does not presently anticipate a material business interruption as a result of the Year 2000, the worst case scenario if all of the Company's Year 2000 efforts failed, including the failure of third party providers to deliver services, could result in daily lost revenues of approximately \$3,200,000. This estimate is based on historical revenues recognized in the months of January, February and March.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

This Management's Discussion and Analysis of Financial Condition and Results of Operations and other sections of this Form 10-Q contain forward-looking statements that are based on current expectations, estimates and projections about the industry in which the Company operates, management's beliefs and assumptions made by management. Words such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions, which are difficult to predict and many of which are outside the Company's control. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. The Company undertakes no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. Readers are cautioned not to put undue reliance on such forward-looking statements. Stockholders may review the Company's reports filed in the future with the Securities and Exchange Commission for more current descriptions of developments that could cause actual results to differ materially from such forward-looking statements.

Factors that could cause or contribute to actual results differing materially from such forward-looking statements include the following: cost of gas; gas sales volumes; weather conditions in the Company's service territories; the achievement of operating efficiencies and the purchases and implementation of new technologies for attaining such efficiencies; impact of relations with labor unions of bargaining-unit employees; the receipt of timely and adequate rate relief; the outcome of pending and future litigation; governmental regulations and proceedings affecting or involving the Company; and the nature and impact of any extraordinary transactions such as any acquisition or divestiture of a business unit or any assets. These are representative of the factors that could affect the outcome of the forward-looking statements. In addition, such statements could be affected by general industry and market conditions, and general economic conditions, including interest rate fluctuations, federal, state and local laws and regulations affecting the retail gas industry or the energy industry generally, and other factors.

SOUTHERN UNION COMPANY AND SUBSIDIARIES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SOUTHERN UNION COMPANY
(Registrant)

Date May 17, 1999

By RONALD J. ENDRES
Ronald J. Endres
Executive Vice President and Chief Financial Officer

Date May 17, 1999

By DAVID J. KVAPIL
David J. Kvapil
Senior Vice President and Corporate Controller
(Principal Accounting Officer)

SOUTHERN UNION COMPANY and PENNSYLVANIA ENTERPRISES INC.
2000 and 2001 Sources and Uses of Funds Forecast
(thousands of dollars)

<u>Significant cash flow items (Note 1)</u>	<u>2000</u>	<u>2001</u>
Depreciation and amortization	\$ 57,100	\$ 61,000
Deferred income taxes	8,000	8,000
Total	<u>\$ 65,100</u>	<u>\$ 69,000</u>

Capital requirements

Construction expenditures (Note 2)	\$ 85,700	\$ 79,800
Long-term debt maturities	2,000	2,100
Total capital requirements	<u>\$ 87,700</u>	<u>\$ 81,900</u>

NOTES

- 1) Projected amounts do not include any effect of potential changes in retail base rates or other regulated activities which could cause the projections to change.
- 2) All of the estimated construction expenditures are subject to continuing review and adjustment and actual construction expenditures may vary from these estimates due to factors such as changes in customers, energy sales, business and economic conditions, construction and design requirements, energy supply and costs, availability of labor, supplies and materials, regulatory treatment, environmental and conservation requirements and existing and proposed legislation. Southern Union Company and Pennsylvania Enterprises Inc. is keeping its construction program as flexible as possible with the intention of accommodating those factors that may develop or change.

AGREEMENT OF MERGER

between

SOUTHERN UNION COMPANY

and

PENNSYLVANIA ENTERPRISES, INC.

Dated as of June 7, 1999

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PNT Disclosure Schedule
SUG Disclosure Schedule

AGREEMENT OF MERGER

This AGREEMENT OF MERGER (this "Agreement") is made as of the 7th day of June, 1999, by and between SOUTHERN UNION COMPANY, a Delaware corporation ("SUG"), and PENNSYLVANIA ENTERPRISES, INC., a Pennsylvania corporation ("PNT").

RECITALS

WHEREAS, the Board of Directors of each of SUG and PNT has approved and deems it advisable and in the best interests of their respective shareholders to consummate the merger of PNT with and into SUG upon the terms and subject to the conditions set forth herein; and

WHEREAS, in furtherance thereof, the Board of Directors of each of SUG and PNT has approved this Agreement and the merger of PNT with and into SUG, with SUG being the surviving corporation (the "Merger");

NOW, THEREFORE, in consideration of the foregoing and the mutual covenants and agreements herein contained, and intending to be legally bound hereby, SUG and PNT hereby agree as follows:

ARTICLE I DEFINITIONS

Section 1.1 Certain Defined Terms. For purposes of this Agreement, the following terms have the meanings specified or referred to in this Article I (such definitions to be equally applicable to both the singular and plural forms of the terms defined):

"Acquired Companies"-- PNT and its Subsidiaries, collectively, and each, an "Acquired Company."

"Applicable Contract"--any Contract (a) under which any Acquired Company has any rights, (b) under which any Acquired Company has any obligation or liability, or (c) by which any Acquired Company or any of the assets owned or used by it is bound.

"Average Trading Price"--of SUG Common Stock, as of any date, will equal the average of the reported closing market prices of such stock for the ten consecutive trading days ending on the third trading day prior to such date (counting from and including the trading day immediately preceding such date). The closing market price for each day in question will be the last sale price, regular way or, if no such sale takes place on such day, the average of the closing bid and asked prices, regular way, in either case as reported in the principal consolidated transaction reporting system of the principal national securities exchange on which SUG Common Stock is listed or admitted to trading.

"CERCLA"--the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended.

"Closing Date"--the date on which the Closing actually takes place.

"COBRA"--the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended, or any successor law, and regulations and rules issued pursuant to that act or any successor law, and also the requirements of Part 6 of Subtitle B of Title I of ERISA.

"Consent"--any approval, consent, ratification, waiver, or other authorization (including any Governmental Authorization).

"Contract"--any agreement, contract, document, instrument, obligation, promise or undertaking (whether written or oral) that is legally binding.

"DGCL"--the Delaware General Corporation Law.

"Encumbrance"--any charge, adverse claim, lien, mortgage, pledge, security interest or other encumbrance.

"Environment"--soil, land surface or subsurface strata, surface waters (including navigable waters, ocean waters, streams, ponds, drainage basins, and wetlands), groundwaters, drinking water supply, stream sediments, ambient air (including indoor air), plant and animal life, and any other environmental medium or natural resource.

"Environmental Law"--any Legal Requirement that requires or relates to:

(a) advising appropriate authorities, employees, and the public of intended or actual releases of pollutants or hazardous substances or materials, violations of discharge limits, or other prohibitions and of the commencements of activities, such as resource extraction or construction, that could have significant impact on the Environment;

(b) preventing or reducing to acceptable levels the release of pollutants or hazardous substances or materials into the Environment;

(c) reducing the quantities, preventing the release, or minimizing the hazardous characteristics of wastes that are generated;

(d) reducing to acceptable levels the risks inherent in the transportation of hazardous substances, pollutants, oil, or other potentially harmful; or

(e) making responsible parties pay private parties, or groups of them, for damages done to their health or the Environment, or permitting self-appointed representatives of the public interest to recover for injuries done to public assets or for damages to natural resources.

"ERISA"--the Employee Retirement Income Security Act of 1974, as amended, or any successor law, and regulations and rules issued pursuant to that act or any successor law.

"Exchange Act"--the Securities Exchange Act of 1934, as amended, or any successor law, and regulations and rules issued by the SEC pursuant to that act or any successor law.

"Facilities"--any real property, leaseholds, or other interests currently or formerly owned or operated by any Acquired Company and any buildings, plants, structures, or equipment (including motor vehicles, tank cars, and rolling stock) currently or formerly owned or operated by any Acquired Company.

"FERC"--the Federal Energy Regulatory Commission or any successor agency.

"Final Order"--an action by a Governmental Body as to which: (a) no request for stay of the action is pending, no such stay is in effect and if any time period is permitted by statute or regulation for filing any request for such stay, such time period has passed; (b) no petition for rehearing, reconsideration or application for review of the action is pending and the time for filing any such petition or application has passed; (c) such Governmental Body does not have the action under reconsideration on its own motion and the time in which such reconsideration is permitted has passed; and (d) no appeal to a court, or a request for stay by a court of the Governmental Body's action is pending or in effect and the deadline for filing any such appeal or request has passed.

"GAAP"--generally accepted United States accounting principles, applied on a consistent basis.

"Governmental Authorization"--any approval, consent, license, franchise, certificate of public convenience and necessity, permit, waiver or other authorization issued, granted, given, or otherwise made available by or under the authority of any Governmental Body or pursuant to any Legal Requirement.

"Governmental Body"--any:

(a) nation, state, county, city, town, village, district or other jurisdiction of any nature;

(b) federal, state, county, local, municipal or other government;

(c) governmental or quasi-governmental authority of any nature (including any governmental agency, branch, department, official or entity and any court or other tribunal); or

(d) body exercising, or entitled to exercise, any administrative, executive, judicial, legislative, police, regulatory or taxing authority or power of any nature.

"Hazardous Activity"--the distribution, generation, handling, importing, management, manufacturing, processing, production, refinement, Release, storage, transfer, transportation, treatment, or use (including any withdrawal or other use of groundwater) of Hazardous Materials

in, on, under, about, or from the Facilities or any part thereof into the Environment, any other act, business, operation, or thing that increases the danger, or risk of danger, or poses an unreasonable risk of harm to persons or property on or off the Facilities, or that may affect the value of the Facilities or the Acquired Companies.

"Hazardous Materials"--any waste or other substance that is listed, defined, designated, or classified as, or otherwise determined to be, hazardous, radioactive, or toxic or a pollutant or a contaminant under or pursuant to any Environmental Law, including any admixture or solution thereof, and specifically including petroleum and all derivatives thereof or synthetic substitutes therefor and asbestos or asbestos-containing materials.

"HSR Act"--the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, or any successor law, and regulations and rules issued by the U.S. Department of Justice or the Federal Trade Commission pursuant to that act or any successor law.

"IRC"--the Internal Revenue Code of 1986, as amended.

"IRS"--the Internal Revenue Service or any successor agency.

"Knowledge"--an individual will be deemed to have "Knowledge" of a particular fact or other matter if such individual is actually aware of such fact or other matter. A Person (other than an individual) will be deemed to have "Knowledge" of a particular fact or other matter if any individual who is serving as a director or officer of such Person or any material Subsidiary of it or other management employee with direct responsibility for such particular fact or other matter of such Person or any material Subsidiary of it (or in any similar capacity) has actual knowledge of such fact or other matter.

"Legal Requirement"--any federal, state, county, local, municipal, foreign, international, multinational, or other administrative order, constitution, law, ordinance, principle of common law, regulation, rule, tariff, franchise agreement, statute or treaty.

"Material Contract"--a Contract involving a total commitment by or to any party thereto of at least \$100,000 on an annual basis or at least \$500,000 on its remaining term which cannot be terminated on no more than sixty (60) days' notice without penalty or additional cost to the Acquired Company as the terminating party.

"Occupational Safety and Health Law"--any Legal Requirement designed to provide safe and healthful working conditions and to reduce occupational safety and health hazards, and any program, whether governmental or private (including those promulgated or sponsored by industry associations and insurance companies), designed to provide safe and healthful working conditions.

"Order"--any award, decision, injunction, judgment, order, ruling, subpoena, or verdict entered, issued, made, or rendered by any court, administrative agency, or other Governmental Body or by any arbitrator.

"Ordinary Course of Business"--an action taken by a Person will be deemed to have been taken in the "Ordinary Course of Business" only if:

(a) such action and authorization therefor is consistent with the past practices of such Person and is taken in the ordinary course of the normal day-to-day operations of such Person; and

(b) such action is not required by law to be authorized by the board of directors (or similar authority) of such Person or of such Person's parent company (if any).

"Organizational Documents"--(a) the articles or certificate of incorporation and the bylaws of a corporation; (b) the partnership agreement and any statement of partnership of a general partnership; (c) the limited partnership agreement and the certificate of limited partnership of a limited partnership; (d) the certificate of formation and the members, operating or similar agreement of a limited liability company; (e) any charter or similar document adopted or filed in connection with the creation, formation or organization of a Person; and (f) any amendment to any of the foregoing.

"PBCL"--the Pennsylvania Business Corporation Law.

"Person"--any individual, corporation (including any non-profit corporation), general or limited partnership, limited liability company, joint venture, estate, trust, association, organization, labor union, organized group of persons, entity of any other type, or Governmental Body.

"PG Preferred Stock"--each series of the cumulative preferred stock, par value \$100.00 per share, of PG Energy.

"PNT Balance Sheet"--the audited consolidated balance sheet of the Acquired Companies at December 31, 1998 (including the notes thereto), provided by PNT to SUG as part of the PNT Financial Statements.

"PNT Common Stock"--the common stock, no par value, of PNT.

"PNT Disclosure Schedule"--the disclosure schedule delivered by PNT to SUG concurrently with the execution and delivery of this Agreement.

"PNT Material Adverse Effect" -- a material adverse effect (i) on the business, operations, financial condition or results of operations of PNT and its Subsidiaries, taken as a whole, or (ii) on the ability of PNT and its Subsidiaries to consummate the Mergers in accordance with this Agreement.

"PNT Permitted Liens"--Encumbrances securing Taxes, assessments, governmental charges or levies, or the claims of materialmen, mechanics, carriers and like persons, all of which are not yet due and payable or which are being contested in good faith; Encumbrances (other than any

Encumbrance imposed by ERISA) incurred on deposits made in the Ordinary Course of Business in connection with worker's compensation, unemployment insurance or other types of social security; the Encumbrances created by and the Encumbrances permitted under the Indenture of Mortgage and Deed of Trust, dated as of March 15, 1946, between PG Energy (formerly known as Scanton-Spring Brook Water Service Company) and Morgan Guaranty Trust Company of New York (formerly known as Guaranty Trust Company of New York), as Trustee, as amended or supplemented from time to time; in the case of leased real property, Encumbrances (not attributable to an Acquired Company as lessee) affecting the landlord's (and any underlying landlord's) interest in any leased real property; and such other Encumbrances which are not, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect.

"Proceeding"--any action, arbitration, hearing, litigation or suit (whether civil, criminal, administrative, investigative, or informal) commenced, brought, conducted, or heard by or before, or otherwise involving, any Governmental Body or arbitrator.

"PUHCA"--the Public Utility Holding Company Act of 1935, as amended, or any successor law, and regulations and rules issued by the SEC pursuant to that act or any successor law.

"Related Documents"--any Contract provided for in this Agreement to be entered into by one or more of the parties hereto or their respective Subsidiaries in connection with the Mergers.

"Release"--any spilling, leaking, emitting, discharging, depositing, escaping, leaching, dumping, or other releasing into the Environment, whether intentional or unintentional.

"Representative"--with respect to a particular Person, any director, officer, employee, agent, consultant, advisor, or other representative of such Person, including legal counsel, accountants, and financial advisors.

"SEC"--the United States Securities and Exchange Commission or any successor agency.

"Securities Act"--the Securities Act of 1933, as amended, or any successor law, and regulations and rules issued by the SEC pursuant to that act or any successor law.

"Subsidiary"--with respect to any Person (the "Owner"), any Person of which securities or other interests having the power to elect a majority of that other Person's board of directors or similar governing body, or otherwise having the power to direct the business and policies of that corporation or other Person (other than securities or other interests having such power only upon the happening of a contingency that has not occurred) are held by the Owner or one or more of its Subsidiaries; when used without reference to a particular Person, "Subsidiary" means a Subsidiary of PNT.

"SUG Balance Sheet"--the audited consolidated balance sheet of SUG at June 30, 1998 (including the notes thereto), provided by SUG to PNT as part of the SUG Financial Statements.

"SUG Common Stock"--the Common Stock, par value \$1.00 per share, of SUG.

"SUG Disclosure Schedule"--the disclosure schedule delivered by SUG to PNT concurrently with the execution and delivery of this Agreement.

"SUG Material Adverse Effect"--a material adverse effect (i) on the business, operations, financial condition or results of operations of SUG and its Subsidiaries, taken as a whole, or (ii) on the ability of SUG to consummate the Mergers in accordance with this Agreement.

"SUG Permitted Liens"--Encumbrances securing Taxes, assessments, governmental charges or levies, or the claims of materialmen, mechanics, carriers and like persons, all of which are not yet due and payable or which are being contested in good faith; Encumbrances (other than any Encumbrance imposed by ERISA) incurred on deposits made in the Ordinary Course of Business in connection with worker's compensation, unemployment insurance or other types of social security; in the case of leased real property, Encumbrances (not attributable to SUG as lessee) affecting the landlord's (and any underlying landlord's) interest in any leased real property; and such other Encumbrances which are not, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect.

"Tax"--any tax (including any income tax, capital gains tax, value-added tax, sales and use tax, franchise tax, payroll tax, withholding tax or property tax), levy, assessment, tariff, duty (including any customs duty), deficiency, franchise fee or payment, payroll tax, utility tax, gross receipts tax or other fee or payment, and any related charge or amount (including any fine, penalty, interest or addition to tax), imposed, assessed or collected by or under the authority of any Governmental Body or payable pursuant to any tax-sharing agreement or any other Contract relating to the sharing or payment of any such tax, levy, assessment, tariff, duty, deficiency or fee.

"Tax Return"--any return (including any information return), report, statement, schedule, notice, form, or other document or information filed with or submitted to, or required to be filed with or submitted to, any Governmental Body in connection with the determination, assessment, collection, or payment of any Tax or in connection with the administration, implementation, or enforcement of or compliance with any Legal Requirement relating to any Tax.

"Threat of Release"--a reasonable likelihood of a Release that will require action under Environmental Laws in order to prevent or mitigate damage to the Environment that may result from such Release.

"Threatened"--a claim, Proceeding, dispute, action, or other matter will be deemed to have been "Threatened" if any demand or statement has been made (orally or in writing) or any notice has been given (orally or in writing), or if any other event has occurred or any other circumstance exists, that would lead a director, officer or management employee of a comparable gas distribution company to conclude that such a claim, Proceeding, dispute, action, or other matter is likely to be asserted, commenced, taken or otherwise pursued in the future.

Section 1.2 Other Defined Terms. In addition to the terms defined in Section 1.1, certain other terms are defined elsewhere in this Agreement as indicated below and, whenever such terms are used in this Agreement, they shall have their respective defined meanings.

<u>TERM</u>	<u>SECTION</u>
4.10% PG Preferred Stock	5.2
5.75% PG Preferred Stock	5.2
Acquired Company Option Plans	3.4
Agreement	Introductory Paragraph
Business Combination	6.1(h)(4)
Cash Consideration	3.1(a)(2)
Certificates	3.2(b)
Closing	2.3
Confidentiality Agreement	6.1(c)
Conversion Price	3.1(a)
Dissenting Shares	3.3
Effective Time	2.2
Employees	6.2(b)
Exchange Ratio	3.1(a)(1)
Honesdale	2.6
Honesdale Merger	2.6
Indemnified Parties	9.1(a)
Initial Termination Date	8.1(j)
Maximum Value	3.1(a)
Merger	Recitals
Merger Consideration	3.1(a)
Mergers	2.6
Minimum Value	3.1(a)
NYSE	3.4
Paying Agent	3.2(a)
PBGC	4.18(b)

PG Energy	2.6
PG Energy Merger	2.6
PNT	Introductory Paragraph
PNT Benefit Plans	5.18(a)
PNT Commonly Controlled Entity	5.18(e)
PNT Financial Statements	5.9
PNT Meeting	6.1(j)(1)
PNT Options	3.4
PNT Proxy Statement	4.23
PNT Rights	3.1(a)
PNT Rights Agreement	3.1(a)
PNT SEC Documents	5.9
PNT Shareholders' Approval	5.25
Registration Statement	4.23
Rule 145 Affiliates	6.1(k)
Rule 145 Letters	6.1(k)
Stock Consideration	3.1(a)(1)
SUG	Introductory Paragraph
SUG Benefit Plans	4.18(a)
SUG Commonly Controlled Entity	4.18(e)
SUG Financial Statements	4.9
SUG Meeting	6.2(m)
SUG Proxy Statement	4.23
SUG SEC Documents	4.9
SUG Shareholders' Approval	4.24
Superior Proposal	6.1(h)
Surviving Corporation	2.1
Third Party Beneficiary	10.11

ARTICLE II THE MERGER; OTHER TRANSACTIONS

Section 2.1 The Merger. Upon the terms and subject to the conditions of this Agreement, at the Effective Time (as defined in Section 2.2), PNT will be merged with and into SUG in accordance with the laws of the State of Delaware and the Commonwealth of Pennsylvania. SUG will be the surviving corporation in the Merger (the "Surviving Corporation") and will continue its corporate existence under the laws of the State of Delaware. The Merger will have the effect as provided in the applicable provisions of the DGCL and the PBCL. Without limiting the generality of the foregoing, upon the Merger, all the rights, privileges, immunities, powers and franchises of PNT and SUG will vest in the Surviving Corporation and all obligations, duties, debts and liabilities of PNT and SUG will be the obligations, duties, debts and liabilities of the Surviving Corporation.

Section 2.2 Effective Time of the Merger. On the Closing Date, with respect to the Merger, (i) a duly executed certificate of merger complying with the requirements of the DGCL will be executed and filed with the Secretary of State of the State of Delaware and (ii) a duly executed articles of merger and plan of merger complying with the requirements of the PBCL will be filed with the Secretary of State of the Commonwealth of Pennsylvania. The Merger will become effective upon filing the certificate of merger with the Secretary of State of the State of Delaware and the articles of merger and plan of merger with the Secretary of State of the Commonwealth of Pennsylvania (the "Effective Time").

Section 2.3 Closing. Unless this Agreement has been terminated and the transactions contemplated herein have been abandoned pursuant to Article VIII hereof, the closing of the transactions contemplated by this Agreement (the "Closing") will take place at 10:00 a.m., Eastern Time, on the Closing Date to be specified by the parties, which shall be no later than the tenth business day after satisfaction or waiver of all of the conditions set forth in Article VII hereof (other than Sections 7.1(a), 7.1(b), 7.1(c), 7.1(f), 7.1(g), 7.1(h), 7.1(k), 7.1(l), 7.2(a), 7.2(b), 7.2(c), 7.2(e), 7.2(f) and 7.2(h), which shall be satisfied or waived on the Closing Date) at the offices of Fleischman and Walsh, L.L.P., counsel to SUG, unless another date or place is agreed to in writing by the parties hereto.

Section 2.4 Certificate of Incorporation; By-laws. Pursuant to the Merger, the Restated Certificate of Incorporation of SUG, as in effect immediately prior to the Effective Time, shall be the Certificate of Incorporation of the Surviving Corporation until thereafter amended as provided by law and (ii) the By-laws of SUG as in effect immediately prior to the Effective Time, shall be the By-laws of the Surviving Corporation until thereafter amended as provided by law.

Section 2.5 Directors and Officers. The directors and officers of SUG immediately prior to the Effective Time will be the directors and officers of the Surviving Corporation, each to hold office in accordance with the Certificate of Incorporation and By-laws of the Surviving Corporation.

Section 2.6 Other Transactions. Immediately after the Effective Time on the Closing Date, the Surviving Corporation shall cause Honesdale Gas Company ("Honesdale"), a wholly-owned Subsidiary of PG Energy, Inc., a Subsidiary of PNT ("PG Energy"), to merge with and into PG Energy by complying with the requirements of the PBCL (the "Honesdale Merger"). Immediately after the consummation of the Honesdale Merger on the Closing Date, the Surviving Corporation shall cause PG Energy to merge with and into SUG, as the Surviving Corporation, by complying with the requirements of the PBCL and the DGCL (the "PG Energy Merger"). The Merger, the Honesdale Merger and the PG Energy Merger shall hereinafter be referred to collectively as the "Mergers."

ARTICLE III CONVERSION OF SHARES

Section 3.1 Effect of the Merger. As of the Effective Time, by virtue of the Merger and without any action on the part of the holders of any shares of PNT Common Stock:

(a) Each issued and outstanding share of PNT Common Stock (other than Dissenting Shares (as defined in Section 3.3) covered by Section 3.3) and each associated stock purchase right (collectively, the "PNT Rights") issued pursuant to the Rights Agreement, dated as of April 26, 1995 between PNT and Chemical Bank, as Rights Agent (the "PNT Rights Agreement"), which will be terminated at the Effective Time (any reference in this Agreement to PNT Common Stock will be deemed to include the associated PNT Rights), will be converted into the right of each holder thereof to receive the following consideration (the "Merger Consideration"):

(1) that number of fully paid and nonassessable shares of SUG Common Stock (the "Stock Consideration") equal to \$32.00 divided by the Conversion Price (as defined below) rounded to the nearest hundred-thousandth (the "Exchange Ratio"); and

(2) an amount in cash without interest (the "Cash Consideration") equal to the sum of \$3.00, plus, if the Average Trading Price of SUG Common Stock as of the Closing Date is less than \$19.46250, the product of (x) the amount of such shortfall not to exceed \$2.16250 and (y) the Exchange Ratio.

"Conversion Price" shall mean the Average Trading Price of SUG Common Stock as of the Closing Date. Notwithstanding the foregoing, if the Conversion Price as calculated pursuant to the preceding sentence and without regard to this sentence (i) is less than the Minimum Value, then the Conversion Price will be equal to the "Minimum Value," or (ii) is greater than the "Maximum Value," then the Conversion Price will be equal to the "Maximum Value." "Minimum Value" will be \$19.46250 and "Maximum Value" will be \$22.70625.

Each holder of PNT Common Stock shall surrender all such holder's certificates formerly representing ownership of PNT Common Stock in the manner provided in Section 3.2. All such shares of PNT Common Stock, when so converted, shall no longer be outstanding and shall be

canceled and automatically converted into the right to receive the Merger Consideration therefor upon the surrender of such certificate in accordance with Section 3.2. Any payment made pursuant to this Section 3.1(a) shall be made net of applicable withholding taxes to the extent such withholding is required by law.

(b) No fractional share of SUG Common Stock shall be issued in connection with the Merger. Each holder of shares of PNT Common Stock shall be entitled to receive in lieu of any fractional share of SUG Common Stock to which such holder otherwise would have been entitled pursuant to this Section 3.1 (after taking into account all shares of PNT Common Stock then held of record by such holder) a cash payment in an amount equal to the product of (i) the fractional interest of a share of SUG Common Stock to which such holder otherwise would have been entitled and (ii) the closing price of a share of SUG Common Stock on the NYSE on the trading day immediately prior to the Effective Time. Payment of such amounts shall be made by SUG.

Section 3.2 Exchange of PNT Common Stock Certificates and PG Preferred Stock Certificates.

(a) SUG's registrar and transfer agent, or such other bank or trust company as may be selected by SUG and be reasonably acceptable to PNT, will act as paying agent ("Paying Agent") for the holders of PNT Common Stock in connection with the Merger, pursuant to an agreement providing for the matters set forth in this Section 3.2 and such other matters as may be appropriate and the terms of which shall be reasonably satisfactory to SUG and PNT, to receive the consideration to which holders of PNT Common Stock become entitled pursuant to Section 3.1. Contemporaneous with the Effective Time, SUG will deposit in trust with the Paying Agent for the benefit of holders of PNT Common Stock, the aggregate Cash Consideration and the SUG Common Stock necessary to pay the aggregate Merger Consideration as contemplated by Section 3.1(a) with respect to each share of PNT Common Stock.

(b) At the Effective Time of the Merger, SUG will instruct the Paying Agent to promptly, and in any event not later than three (3) business days following the Effective Time, mail (and to make available for collection by hand) to each holder of record of a certificate or certificates, which immediately prior to the Effective Time represented outstanding shares of PNT Common Stock (the "Certificates"), whose shares of PNT Common Stock were converted pursuant to Section 3.1(a) into the right to receive the Merger Consideration (i) a letter of transmittal (which shall specify that delivery shall be effected, and risk of loss and title to the Certificates shall pass, only upon delivery of the Certificates to the Paying Agent and shall be in such form and have such other provisions as SUG may reasonably specify) and (ii) instructions (which shall provide that at the election of the surrendering holder Certificates may be surrendered, and payment therefor collected, by hand delivery) for use in effecting the surrender of the Certificates in exchange for payment of the Merger Consideration. Upon surrender of a Certificate for cancellation to the Paying Agent or to such other agent or agents as may be appointed by SUG, together with such letter of transmittal, duly executed, the holder of such Certificate shall be entitled to receive in exchange therefor the Merger Consideration for each share of PNT Common Stock formerly represented by such Certificate, to be mailed (or made available for collection by

hand if so elected by the surrendering holder) within three (3) business days of receipt thereof, and the Certificate so surrendered shall forthwith be canceled. If payment of the Merger Consideration is to be made to a Person other than the Person in whose name the surrendered Certificate is registered, it shall be a condition of payment that the Certificate so surrendered shall be properly endorsed or shall be otherwise in proper form for transfer and that the Person requesting such payment shall have paid any transfer and other Taxes required by reason of the payment of the Merger Consideration to a Person other than the registered holder of the Certificate surrendered or shall have established to the satisfaction of the Surviving Corporation that such Tax either has been paid or is not applicable. Until surrendered as contemplated by this Section 3.2, each Certificate (other than Certificates representing PNT Common Stock held by SUG or Dissenting Shares) shall be deemed at any time after the Effective Time to represent only the right to receive the Merger Consideration as contemplated by this Section 3.2.

(c) The Paying Agent shall invest the funds representing the aggregate Cash Consideration, as directed by SUG, in (i) direct obligations of the United States of America, (ii) obligations for which the full faith and credit of the United States of America is pledged to provide for the payment of principal and interest or (iii) commercial paper rated the highest quality by either Moody's Investors Service, Inc., or Standard and Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc. Any net earnings with respect to such funds shall be the property of and paid over to SUG as and when requested by SUG; provided, however, that any such investment or any such payment of earnings may not delay the receipt by holders of Certificates of the Merger Consideration.

(d) In the event any Certificate shall have been lost, stolen or destroyed, upon the making of an affidavit of that fact by the Person claiming such Certificate to be lost, stolen or destroyed, the Paying Agent will issue in exchange for such lost, stolen or destroyed Certificate the Merger Consideration deliverable in respect thereof as determined in accordance with this Article III, provided that the Person to whom the Merger Consideration is paid shall, as a condition precedent to the payment thereof, give the Paying Agent a bond in such sum as it may ordinarily require and indemnify the Surviving Corporation in a manner satisfactory to it against any claim that may be made against the Surviving Corporation with respect to the Certificate claimed to have been lost, stolen or destroyed.

(e) After the Effective Time, the stock transfer books of PNT shall be closed and there shall be no transfers on the stock transfer books of the Surviving Corporation of shares of PNT Common Stock that were outstanding immediately prior to the Effective Time. If, after the Effective Time, Certificates are presented to the Surviving Corporation, they shall be canceled and exchanged for the Merger Consideration as provided in this Article III.

(f) Any portion of the funds held by the Paying Agent that remain undistributed to the former shareholders of PNT for eighteen (18) months after the Effective Time shall be delivered by the Paying Agent to the Surviving Corporation, which shall thereafter act as the Paying Agent, and any former shareholders of PNT who have not complied with this Article III prior to eighteen (18) months after the Effective Time shall thereafter look only as a general creditor to the Surviving Corporation for payment of their claim for the Merger Consideration.

(g) The Surviving Corporation shall not be liable to any holder of PNT Common Stock for Merger Consideration delivered to a public official pursuant to any applicable abandonment, escheat or similar law. Any amounts remaining unclaimed by holders of any such shares of PNT Common Stock seven years after the Effective Time (or such earlier date immediately prior to the time at which such amounts would otherwise escheat to or become property of any Governmental Body) shall, to the extent permitted by applicable law, become the property of the Surviving Corporation, free and clear of any claims or interest of any such holders or their successors, assigns or personal representatives previously entitled thereto.

Section 3.3 Dissenting Shares. Notwithstanding anything in this Agreement to the contrary, shares of PNT Common Stock outstanding immediately prior to the Effective Time the holder of which filed with PNT, prior to the vote to secure the PNT Shareholders' Approval, a written notice of intention to demand payment (collectively, the "Dissenting Shares"), shall not be converted into the right to receive the Merger Consideration, as provided in Section 3.1(a) hereof, unless and until such holder fails to perfect or effectively withdraws or otherwise loses his right to appraisal and payment under the PBCL. If, after the Effective Time, any holder of PNT Common Stock fails to perfect or effectively withdraws or loses his right to appraisal, such Dissenting Shares shall thereupon be treated as if they had been converted as of the Effective Time into the right to receive the Merger Consideration to which such holder is entitled, without interest or dividends thereon. PNT shall give SUG prompt notice of any demands received by PNT for appraisal of PNT Common Stock, and, prior to the Effective Time, SUG shall have the right to participate in all negotiations and proceedings with respect to such demands. Prior to the Effective Time, PNT shall not, except with the prior written consent of SUG, make any payment with respect to or offer to settle, any such demands.

Section 3.4 PNT Option Plans. Each outstanding option to purchase shares of PNT Common Stock or other similar interest (collectively, the "PNT Options"), granted under any stock option plans or under any other plan or arrangement of any Acquired Company (the "Acquired Company Option Plans") together with the applicable exercise prices, are disclosed in Section 5.18 of the PNT Disclosure Schedule. Unless otherwise agreed by the parties hereto, each PNT Option under the PNT 1992 Stock Option Plan as to which the holder has consented to a conversion to cash and each PNT Option under the PNT Stock Incentive Plan that is outstanding at the Effective Time shall be converted at the Effective Time into a right to receive in respect thereof a cash payment in an amount equal to the product of (x) the amount by which (i) the sum of the Cash Consideration plus the product of (a) the Exchange Ratio and (b) the closing price of a share of SUG Common Stock on the New York Stock Exchange (the "NYSE") on the trading day immediately prior to the date on which the Effective Time occurs exceeds (ii) the exercise price of such PNT Option (if less than (i)) and (y) the number of shares of PNT Common Stock subject thereto. Such cash payment (net of applicable withholding taxes) shall be made on the Closing Date or as promptly thereafter as reasonably practicable. PNT shall use its reasonable best efforts to obtain the consent of holders of options outstanding under the 1992 Stock Option Plan to a conversion to cash in accordance herewith. PNT Options under the 1992 Stock Option Plan as to which consent is not obtained shall be converted into such number of options to purchase SUG Common Stock such that the aggregate option value, based on the Merger Consideration, and the

aggregate exercise price are preserved and otherwise having the same terms as the PNT Options being converted.

**ARTICLE IV
REPRESENTATIONS AND WARRANTIES
OF SUG**

SUG, as to SUG and its Subsidiaries, represents and warrants to PNT that:

Section 4.1 Organization, Existence and Qualification. SUG is a corporation duly incorporated, validly existing, and in good standing under the laws of the State of Delaware, with full corporate power and authority to conduct its business as it is now being conducted, to own or use the properties and assets that it purports to own or use, to perform its obligations under all Contracts to which it is a party, and to execute and deliver this Agreement. SUG is duly qualified to do business as a foreign corporation and is in good standing under the laws of each state or other jurisdiction in which either the ownership or use of the properties owned or used by it, or the nature of the business conducted by it, requires such qualification as a foreign corporation except such failures to be so qualified or in good standing as are not, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect.

Section 4.2 Capitalization. The authorized capital stock of SUG consists of (i) 50,000,000 shares of SUG Common Stock, of which 29,745,234 shares were issued and outstanding on May 28, 1999, and (ii) 1,500,000 shares of Cumulative Preferred Stock, no par value, none of which are issued or outstanding. The issued and outstanding shares of SUG Common Stock have been validly issued and are fully paid and nonassessable. The shares of SUG Common Stock to be issued as part of the Merger Consideration have been duly authorized and when issued and delivered in accordance with the terms of this Agreement, will have been validly issued and will be fully paid and nonassessable and the issuance thereof is not subject to any preemptive or other similar right. Except as specifically described in the SUG SEC Documents delivered to PNT prior to the date of this Agreement, as of the date of this Agreement, no shares of SUG Common Stock are held, in treasury or otherwise, by SUG or any of its Subsidiaries and except as set forth in Section 4.2 of the SUG Disclosure Schedule, there are no outstanding (i) securities convertible into SUG Common Stock or other capital stock of SUG or any of its material Subsidiaries, (ii) warrants or options to purchase SUG Common Stock or other securities of SUG or any of its material Subsidiaries or (iii) commitments to issue shares of SUG Common Stock (other than pursuant to the Merger) or other securities of SUG or any of its material Subsidiaries.

Section 4.3 Subsidiaries; Investments. Except as set forth in Section 4.3 of the SUG Disclosure Schedule, as of the date of this Agreement, SUG has no Subsidiaries or investments in any Person except for marketable securities reflected in the SUG SEC Documents delivered to PNT prior to the date of this Agreement, and SUG is the registered owner and holder of all of the issued and outstanding shares of capital stock of its Subsidiaries and has good title to such shares. The outstanding capital stock of each material Subsidiary of SUG has been validly issued and is fully paid and nonassessable. All such capital stock owned by SUG or any of its Subsidiaries is

free and clear of any Encumbrance (except for any Encumbrance imposed by federal or state securities laws).

Section 4.4 Authority Relative to this Agreement and Binding Effect. The execution, delivery and performance of this Agreement and the Related Documents by SUG have been duly authorized by all requisite corporate action, except, as of the date of this Agreement, for the SUG Shareholders' Approval. Except as set forth in Section 4.4 of the SUG Disclosure Schedule, the execution, delivery and performance of this Agreement and the Related Documents by SUG will not result in a violation or breach of any term or provision of, or constitute a default or accelerate the performance required under, the Organizational Documents of SUG, any indenture, mortgage, deed of trust, security agreement, loan agreement, or Material Contract to which SUG is a party or by which its assets are bound, or violate any order, writ, injunction or decree of any Governmental Body, with such exceptions as are not, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect. This Agreement constitutes and the Related Documents to be executed by SUG when executed and delivered will constitute valid and binding obligations of SUG, enforceable against SUG in accordance with their terms, except as enforceability may be limited by (i) bankruptcy or similar laws from time to time in effect affecting the enforcement of creditors' rights generally or (ii) the availability of equitable remedies generally.

Section 4.5 Governmental Approvals. Except for the Missouri Public Service Commission (with respect to the Mergers), the Florida Public Service Commission (with respect to the securities issued and debt assumed by SUG in connection with the Mergers), the Pennsylvania Public Utility Commission and as required by the HSR Act, no approval or authorization of any Governmental Body with respect to performance under this Agreement by SUG is required to be obtained by SUG in connection with the execution and delivery by SUG of this Agreement or the consummation of the transactions contemplated by this Agreement, the failure to obtain which are, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect.

Section 4.6 Public Utility Holding Company Status; Regulation as a Public Utility. SUG is a "gas utility company" (as such term is defined in PUHCA). SUG indirectly owns a minority interest in a "foreign utility company" (as such term is defined in PUHCA) that is exempt from, and is deemed not to be a public utility company for purposes of, PUHCA pursuant to Section 33 thereof with respect to which SUG has filed with the SEC a Form U-57 notification of foreign utility company status. Except as stated above in this Section 4.6, neither SUG nor any of its Subsidiaries is a "holding company," a "subsidiary company," a "public utility company" or an "affiliate" of a "public utility company," or a "holding company" within the meaning of such terms in PUHCA.

Section 4.7 Compliance with Legal Requirements; Governmental Authorizations.

(a) Except as set forth in Section 4.7 of the SUG Disclosure Schedule or specifically described in the SUG SEC Documents delivered to PNT prior to the date of this Agreement, and subject to Section 4.19 of this Agreement, to the Knowledge of SUG, SUG is not

in violation of any Legal Requirement that is applicable to it, to the conduct or operation of its business, or to the ownership or use of any of its assets, other than such violations, if any, which are not, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect.

(b) The SUG SEC Documents delivered to PNT prior to the date of this Agreement accurately describe all material regulation of SUG that relates to the utility business of SUG. Except as set forth in Section 4.7 of the SUG Disclosure Schedule, SUG has and is in material compliance with all material Governmental Authorizations necessary to conduct its business and to own, operate and use all of its assets as currently conducted.

Section 4.8 Legal Proceedings; Orders. Except as set forth in Section 4.8 of the SUG Disclosure Schedule or as specifically described in the SUG SEC Documents delivered to PNT prior to the date of this Agreement, there is no pending Proceeding:

(1) that has been commenced by or against, or that otherwise relates to, SUG that is reasonably likely to have an SUG Material Adverse Effect; or

(2) as of the date of this Agreement, that challenges, or that may have the effect of preventing, delaying, making illegal, or otherwise interfering with, the Mergers or any of the transactions contemplated hereby.

To the Knowledge of SUG, no such Proceedings, audits or investigations have been Threatened that are, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect.

Section 4.9 SEC Documents. SUG has made (and, with respect to such documents filed after the date hereof through the Closing Date, will make) available to PNT a true and complete copy of each report, schedule, registration statement (other than on Form S-8), and definitive proxy statement filed by SUG with the SEC since June 30, 1998 and through the Closing Date in substantially the form filed with the SEC (the "SUG SEC Documents"). As of their respective dates, the SUG SEC Documents, including without limitation any financial statements or schedules included therein, complied (or will comply), in all material respects with the requirements of the Securities Act or the Exchange Act, as the case may be, and the rules and regulations of the SEC thereunder applicable to such SUG SEC Documents, and did not (or will not) contain any untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made, not misleading. The audited consolidated financial statements and unaudited interim financial statements of SUG included in the SUG SEC Documents (collectively, the "SUG Financial Statements") were (or will be) prepared in accordance with GAAP applied on a consistent basis (except as may be indicated therein or in the notes thereto and except with respect to unaudited statements as permitted by Form 10-Q) and fairly present (or will fairly present) in all material respects the financial position of SUG as of the respective dates thereof or the results of operations and cash flows for the respective periods then ended, as the case may be,

subject, in the case of unaudited interim financial statements, to normal, recurring adjustments which are not material in the aggregate.

Section 4.10 Taxes. Except as set forth in Section 4.10 of the SUG Disclosure Schedule:

(a) SUG and its Subsidiaries have timely filed all United States federal, state and local income Tax Returns required to be filed by or with respect to them or requests for extensions to file such Tax Returns have been timely filed, granted and have not expired, and SUG and its Subsidiaries have timely paid and discharged all Taxes due in connection with or with respect to the periods or transactions covered by such Tax Returns and have paid all other Taxes as are due or made adequate provision therefor in accordance with GAAP except where the failures to so file, pay or discharge are not, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect. There are no pending audits or other examinations relating to any Tax matters. There are no Tax liens on any assets of SUG or its Subsidiaries. As of the date of this Agreement, SUG and its Subsidiaries have not granted any waiver of any statute of limitations with respect to, or any extension of a period for the assessment of, any Tax. The accruals and reserves (including deferred taxes) reflected in the SUG Balance Sheet are in all material respects adequate to cover all material Taxes accruable through the date thereof (including interest and penalties, if any, thereon and Taxes being contested) in accordance with GAAP.

(b) Neither SUG nor any of its Subsidiaries is obligated under any Contract with respect to industrial development bonds or other obligations with respect to which the excludability from gross income of the holder for federal or state income tax purposes could be affected by the Merger or any of the transactions contemplated by this Agreement.

Section 4.11 Intellectual Property. SUG has no Knowledge of (i) any infringement or claimed infringement by it of any patent rights or copyrights of others or (ii) any infringement of the patent or patent license rights, trademarks or copyrights owned by or under license to it, except for any such infringements of the type described in clause (i) or (ii) that are not, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect.

Section 4.12 Title to Assets. Except (i) as set forth in Section 4.12 of the SUG Disclosure Schedule, (ii) as specifically described in the SUG SEC Documents delivered to PNT prior to the date of this Agreement, (iii) as set forth in Section 4.19 of this Agreement or (iv) as set forth in Section 4.19 of the SUG Disclosure Schedule, none of SUG's assets are subject to any Encumbrance other than SUG Permitted Liens.

Section 4.13 Indebtedness. All outstanding principal amounts of indebtedness for borrowed money of SUG as of June 4, 1999 are set forth in Section 4.13 of the SUG Disclosure Schedule.

Section 4.14 Machinery and Equipment. Except for normal wear and tear and with such other exceptions as are not, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect, SUG's machinery and equipment is in good operating condition and in a state of reasonable maintenance and repair.

Section 4.15 Material Contracts. Except as described in Section 4.15 of the SUG Disclosure Schedule or as specifically described in the SUG SEC Documents delivered to PNT prior to the date of this Agreement, and with such exceptions as are not, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect, all of SUG's Material Contracts are in full force and effect and neither SUG nor, to the Knowledge of SUG, any other party thereto is in default thereunder nor has any event occurred or is any event occurring that, with notice or the passage of time or otherwise, is reasonably likely to give rise to an event of default thereunder by any party thereto.

Section 4.16 Insurance. Section 4.16 of the SUG Disclosure Schedule sets forth a list of all policies of insurance held by SUG as of the date of this Agreement. Since June 30, 1994, the assets and the business of SUG have been continuously insured with what SUG reasonably believes are reputable insurers against all risks and in such amounts normally insured against by companies of the same type and in the same line of business as SUG. As of the date of this Agreement, no notice of cancellation, non-renewal or material increase in premiums has been received by SUG with respect to such policies, and SUG has no Knowledge of any fact or circumstance that could reasonably be expected to form the basis for any cancellation, non-renewal or material increase in premiums, except for such cancellations, non-renewals and increases which are not, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect. SUG is not in default with respect to any provision contained in any such policy or binder nor has there been any failure to give notice or to present any claim relating to the business or the assets of SUG under any such policy or binder in a timely fashion or in the manner or detail required by the policy or binder, except for such defaults or failures which are not, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect. As of the date of this Agreement, there are no outstanding unpaid premiums (except premiums not yet due and payable), and no notice of cancellation or renewal with respect to, or disallowance of any claim under, any such policy or binder has been received by SUG as of the date hereof, except for such non-payments of premiums, cancellations, renewals or disallowances which are not, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect.

Section 4.17 Employees. Except as set forth on Section 4.17 of the SUG Disclosure Schedule, as of the date of this Agreement, no labor union or other collective bargaining unit has been certified or recognized by SUG or its Subsidiaries, and, to the Knowledge of SUG, as of the date of this Agreement, there are no elections, organizing drives or material controversies pending or Threatened between SUG or its Subsidiaries and any labor union or other collective bargaining unit representing SUG's or its Subsidiaries' employees. There is no pending or, to the Knowledge of SUG, Threatened labor practice complaint, arbitration, labor strike or other material labor dispute (excluding grievances) involving SUG or its Subsidiaries which are, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect. Except as described in Section 4.18 or specifically described in the SUG SEC Documents delivered to PNT prior to the date of this Agreement, as of the date of this Agreement, neither SUG nor its Subsidiaries are a party to any employment agreement with any employee pertaining to SUG or any of its Subsidiaries.

Section 4.18 Employee Benefit Plans.

(a) Each of the **SUG Benefit Plans** has been operated and administered in all material respects in accordance with its governing documents and applicable federal and state laws (including, but not limited to, ERISA and the IRC). For purposes of this Agreement, "**SUG Benefit Plans**" shall mean all employee retirement, welfare or other benefit plans, agreements, practices, policies, programs, or arrangements identified and described in Section 4.18 of the **SUG Disclosure Schedule**, which sets forth all **SUG Benefit Plans** that are applicable to any employee of **SUG** or its **Subsidiaries** employed by **SUG** or its **Subsidiaries** thirty (30) days prior to the date of this Agreement or maintained by or contributed to by **SUG** or its **Subsidiaries**.

(b) As to any **SUG Benefit Plan** subject to Title IV of ERISA, there is no event or condition which presents the material risk of plan termination, no accumulated funding deficiency, whether or not waived, within the meaning of Section 302 of ERISA or Section 412 of the IRC has been incurred for which any liability is outstanding, no reportable event within the meaning of Section 4043 of ERISA (for which the notice requirements of Regulation §4043 promulgated by the Pension Benefit Guaranty Corporation ("**PBGC**") have not been waived) has occurred within the last six years, no notice of intent to terminate the **SUG Benefit Plan** has been given under Section 4041 of ERISA, no proceeding has been instituted under Section 4042 of ERISA to terminate the **SUG Benefit Plan**, there has been no termination or partial termination of the **SUG Benefit Plan** within the meaning of Section 411(d)(3) of the IRC within the last six years, except with respect to the conversion of the retirement income plan to a cash balance plan for which full vesting was granted with respect to affected employees, no event described in Sections 4062 or 4063 of ERISA has occurred, all **PBGC premiums** have been timely paid and no liability to the **PBGC** has been incurred, except for **PBGC premiums** not yet due.

(c) There is no matter pending (other than qualification determination applications and filings and other required periodic filings) with respect to any of the **SUG Benefit Plans** before the IRS, the Department of Labor, the **PBGC** or in or before any other governmental authority.

(d) Each trust funding an **SUG Benefit Plan**, which trust is intended to be exempt from federal income taxation pursuant to Section 501(c)(9) of the IRC, satisfies the requirements of such section and has, whenever required by law, received a favorable *determination letter* from the IRS regarding such exempt status and, to the Knowledge of **SUG** has not, since receipt of the most recent favorable determination letter, been amended or operated in any way which would adversely affect such exempt status.

(e) With respect to any **SUG Benefit Plan** or any other "employee benefit plan" as defined in Section 3(3) of ERISA which is established, sponsored, maintained or contributed to, or has been established, sponsored, maintained or contributed to or, to the Knowledge of **SUG**, with respect to any such plan which has been established, sponsored, maintained or contributed to within six years prior to the Closing Date, by **SUG** or its **Subsidiaries** or any corporation, trade, business or entity under common control or being a part of an affiliated service group with **SUG**, within the meaning of Section 414(b), (c) or (m) of the IRC or Section 4001 of ERISA ("**SUG**

Commonly Controlled Entity”), (i) no withdrawal liability, within the meaning of Section 4201 of ERISA, has been incurred, which withdrawal liability has not been satisfied and no such withdrawal liability is reasonably expected to be incurred, (ii) no liability under Title IV of ERISA (including, but not limited to, liability to the PBGC) has been incurred by **SUG** or any **SUG** Commonly Controlled Entity, which liability has not been satisfied (other than for PBGC premiums not yet due), (iii) no accumulated funding deficiency, whether or not waived, within the meaning of Section 302 of ERISA or Section 412 of the IRC has been incurred for which any liability is outstanding, (iv) there has been no failure to make any contribution (including installments) to such plan required by Section 302 of ERISA and Section 412 of the IRC which has resulted in a lien under Section 302 of ERISA or Section 412 of the IRC and for which any liability is currently outstanding, (v) to the Knowledge of **SUG**, no action, omission or transaction has occurred with respect to any such plan or any other **SUG** Benefit Plan which could subject **SUG** or the plan or trust forming a part thereof to a material civil liability or penalty under ERISA or other applicable laws, or a material Tax under the IRC, (vi) any such plan which is a Group Health Plan has complied in all material respects with the provisions of Sections 601-608 of ERISA and Section 4980B of the IRC, (vii) there are no pending or, to the Knowledge of **SUG**, Threatened claims by or on behalf of any such plan or any other **SUG** Benefit Plan, by any employees, former employees or plan beneficiaries covered by such plan or otherwise by or on behalf of any person involving any such plan (other than routine non-contested claims for benefits) which could result in a material liability to **SUG** and its Subsidiaries, taken as a whole, and (viii) neither **SUG** nor any **SUG** Commonly Controlled Entity has engaged in, or is a successor or parent corporation to any entity or person that has engaged in, a transaction described in Section 4069 of ERISA.

(f) The execution and delivery of this Agreement and the consummation of the transactions contemplated hereby will not (i) require **SUG** to make a later contribution to, payment or transfer of money or property or payment of greater benefits under or with respect to any **SUG** Benefit Plan than **SUG** or its Subsidiaries are currently required by the terms and provisions of such **SUG** Benefit Plan to do, (ii) create or give rise to any additional eligibility for participation, vested rights benefits or service credits under any **SUG** Benefit Plan, or (iii) in and of themselves cause or result in **SUG** incurring any civil liability or penalty under ERISA or other applicable laws or Tax under the IRC.

(g) **SUG** is not a party to any Contract nor has it established any policy or practice, which would require **SUG** to make a payment or provide any other form of compensation or benefit to any Person performing (or who within the past twelve months performed) services for **SUG** during or upon termination of such services which would not be payable or provided in the absence of the consummation of the transactions contemplated by this Agreement.

(h) Except as would affect unionized employees and/or retirees who had been unionized employees, each **SUG** Benefit Plan which is an “employee welfare benefit plan,” as such term is defined in Section 3(1) of ERISA, may be unilaterally amended or terminated in its entirety without any liability being incurred by **SUG** or any affiliate of **SUG**, except as to benefits accrued thereunder prior to such amendment or termination.

(i) Section 4.18 of the SUG Disclosure Schedule contains a true and complete list as of the date of this Agreement of each SUG Benefit Plan, all stock option plans of SUG and any management, employment, deferred compensation, severance (including any payment, right or benefit resulting from a change in control), bonus or other contract for personal services with any current or former officer, director or employee, any consulting contract with any person who prior to entering this such contract was a director or officer of SUG or any plan, agreement, arrangement or understanding similar to any of the foregoing.

(j) SUG has not contributed nor been obligated to contribute to any "multi-employer plan" within the meaning of Section 3(37) of ERISA within the last six years and has no outstanding liability with respect to any such plan.

Section 4.19 Environmental Matters. Except as set forth in Section 4.19 of the SUG Disclosure Schedule or as specifically described in the SUG SEC Documents delivered to PNT prior to the date of this Agreement, and with such other exceptions as are not, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect:

(a) To the Knowledge of SUG, no Facility owned or operated by SUG is currently, or was at any time, listed on the National Priorities List promulgated under CERCLA, or on any comparable state list, and SUG has not received any written notification of potential or actual liability or a written request for information from any Person under or relating to CERCLA or any comparable Legal Requirement with respect to SUG or the Facilities;

(b) To the Knowledge of SUG, SUG and any Person for whose conduct SUG is reasonably likely to be held responsible, and at all times has been, in material compliance with any Environmental Law. SUG has not received any Order, notice, or other communication from (i) any Governmental Body or private citizen acting in the public interest, or (ii) the current or prior owner or operator of any Facilities, of any violation or failure to comply with any Environmental Law, or of any obligation to undertake or bear the cost of any environmental cleanup, or with respect to any property or Facility at which Hazardous Materials generated by SUG or any other Person for whose conduct SUG may be held responsible were transported for disposal;

(c) There are no pending or, to the Knowledge of SUG, Threatened claims or Encumbrances arising under or pursuant to any Environmental Law with respect to or affecting any of the Facilities or any other properties and assets (whether real, personal, or mixed) in which SUG has or had a direct or indirect interest (including by ownership or use); and

(d) SUG has delivered or made available to PNT true and complete copies and results of any environmental site assessments, studies, analyses, tests or monitoring possessed by SUG and of which it has Knowledge pertaining to Hazardous Materials or Hazardous Activities in, on or under the Facilities, or concerning compliance by SUG or any other Person for whose conduct SUG is reasonably likely to be held responsible, with Environmental Laws.

Section 4.20 No Material Adverse Change. Except as described in the SUG SEC Documents that have been provided to PNT prior to the date of this Agreement, since the date of the SUG Balance Sheet, there has not been any SUG Material Adverse Effect, and no events have occurred or circumstances exist that are, individually or in the aggregate, reasonably likely to have an SUG Material Adverse Effect, except that any SUG Material Adverse Effect that results from or relates to (a) general business or economic conditions, (b) conditions generally affecting the industries in which SUG competes or (c) the announcement of the transactions contemplated by this Agreement shall be disregarded.

Section 4.21 Brokers. SUG is not a party to, or in any way obligated under any Contract, and there are no outstanding claims against SUG, for the payment of any broker's or finder's fees in connection with the origin, negotiation, execution or performance of this Agreement.

Section 4.22 Regulatory Proceedings. Except as set forth in Section 4.22 of the SUG Disclosure Schedule, other than purchase gas adjustment provisions, SUG (a) has no rates that have been or are being collected subject to refund, pending final resolution of any rate proceeding pending before a Governmental Body or on appeal to the courts, or (b) is a party to any rate proceeding before a Governmental Body that are, individually or in the aggregate, reasonably likely to result in any Orders having an SUG Material Adverse Effect.

Section 4.23 Proxy Statement; Registration Statement. None of the information supplied or to be supplied to PNT by or on behalf of SUG for inclusion in the proxy statement, in definitive form, relating to the PNT Meeting (as defined in Section 6.1(j)) to be held in connection with the Merger (the "PNT Proxy Statement"), supplied or to be supplied by or on behalf of SUG in the proxy statement, in definitive form, relating to the SUG Meeting (as defined in Section 6.2(m)) to be held in connection with the Merger (the "SUG Proxy Statement") or supplied by or on behalf of SUG in the Registration Statement on Form S-4 (and any amendments thereto) to be filed by SUG with the SEC pursuant to the Securities Act to register the shares of SUG Common Stock constituting the Stock Consideration (the "Registration Statement") will, in the case of the Registration Statement, at the effective time of the Registration Statement, at any time the Registration Statement is amended or supplemented, at the date the PNT Proxy Statement is first mailed to PNT's shareholders, at any time the PNT Proxy Statement is amended or supplemented, at the time of the PNT Meeting and at the Effective Time, in the case of the PNT Proxy Statement, at the date the PNT Proxy Statement is first mailed to PNT's shareholders, at any time the PNT Proxy Statement is amended or supplemented and at the time of the PNT Meeting, and in the case of the SUG Proxy Statement, at the date the SUG Proxy Statement is first mailed to SUG's shareholders, at any time the SUG Proxy Statement is amended or supplemented and at the time of the SUG Meeting (giving effect to any documents incorporated by reference therein), contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary in order to make the statements therein, in light of the circumstances under which they are made, not misleading. The Registration Statement will comply as to form and in substance in all material respects with the applicable provisions of the Securities Act and the rules and regulations thereunder. The SUG Proxy Statement will comply

as to form and in substance in all material respects with the applicable provisions of the Exchange Act and the rules and regulations thereunder.

Section 4.24 Vote Required. At the SUG Meeting, SUG will seek the approval of the Merger (and any other transaction contemplated by this Agreement which requires the approval of SUG's shareholders) by the holders of a majority of the outstanding shares of SUG Common Stock (the "SUG Shareholders' Approval"), and no other vote of the holders of any class or series of the capital stock of SUG is required to approve this Agreement and the Mergers.

Section 4.25 Disclaimer of Representations and Warranties EXCEPT FOR THE REPRESENTATIONS AND WARRANTIES CONTAINED IN THIS ARTICLE IV, SUG MAKES NO OTHER REPRESENTATIONS OR WARRANTIES, EXPRESS OR IMPLIED, AND SUG HEREBY DISCLAIMS ANY SUCH OTHER REPRESENTATIONS OR WARRANTIES, WHETHER BY SUG, ANY SUBSIDIARY OF SUG, OR ANY OF THEIR RESPECTIVE OFFICERS, DIRECTORS, EMPLOYEES, AGENTS OR REPRESENTATIVES, OR ANY OTHER PERSON, WITH RESPECT TO THIS AGREEMENT AND THE TRANSACTIONS CONTEMPLATED HEREBY, NOTWITHSTANDING THE DELIVERY OR DISCLOSURE TO PNT OR ANY OF ITS DIRECTORS, OFFICERS, EMPLOYEES, AGENTS OR REPRESENTATIVES, OR ANY OTHER PERSON, OF ANY DOCUMENTATION OR OTHER INFORMATION BY SUG, ANY SUBSIDIARY OF SUG, OR ANY OF THEIR RESPECTIVE DIRECTORS, OFFICERS, EMPLOYEES, AGENTS OR REPRESENTATIVES, OR ANY OTHER PERSON, WITH RESPECT TO ANY OF THE FOREGOING.

ARTICLE V REPRESENTATIONS AND WARRANTIES OF PNT

PNT, as to the Acquired Companies, represents and warrants to SUG as follows:

Section 5.1 Organization, Existence and Qualification.

(a) Each Acquired Company is a corporation duly incorporated, validly existing, and in good standing under the laws of its state of incorporation, with full corporate power and authority to conduct its business as it is now being conducted, to own or use the properties and assets that it purports to own or use, and to perform all its obligations under Applicable Contracts. Section 5.1(a) of the PNT Disclosure Schedule sets forth the name of each Acquired Company, the state or jurisdiction of its incorporation or formation, and, except as set forth on Section 5.1(a) of the PNT Disclosure Schedule, each state or jurisdiction where such Acquired Company is duly qualified as a foreign corporation. Each Acquired Company is duly qualified to do business as a foreign corporation and is in good standing under the laws of each state or other jurisdiction in which either the ownership or use of the properties owned or used by it, or the nature of the business conducted by it, requires such qualification as a foreign corporation except such failures to be so qualified or in good standing as are not, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect.

(b) PNT has delivered to SUG copies of the Organizational Documents, as currently in effect, of each Acquired Company.

Section 5.2 Capitalization. The capital stock of PNT consists of 30,000,000 shares of PNT Common Stock, of which 10,835,270 shares were issued and outstanding on May 28, 1999. PG Energy is authorized to issue 997,500 shares of PG Preferred Stock, of which (i) 47,451 shares of the Series 4.10% PG Preferred Stock (the "4.10% PG Preferred Stock"), and (ii) 2,396 shares of the Series 5.75% PG Preferred Stock (the "5.75% PG Preferred Stock"), were issued and outstanding on May 28, 1999. The issued and outstanding shares of PNT Common Stock and PG Preferred Stock have been validly issued and are fully paid and nonassessable. Except as specifically described in the PNT SEC Documents delivered to SUG prior to the date of this Agreement, as of the date of this Agreement, no shares of PNT Common Stock or PG Preferred Stock are held, in treasury or otherwise, by PNT or any of its Subsidiaries and except as set forth in Section 5.2 of the PNT Disclosure Schedule, there are no outstanding (i) securities convertible into PNT Common Stock, PG Preferred Stock or other capital stock PNT or any of its material Subsidiaries, (ii) warrants or options to purchase PNT Common Stock or other securities of PNT or any of its material Subsidiaries or (iii) other commitments to issue shares of any PNT Common Stock, PG Preferred Stock or other securities of PNT or any of its material Subsidiaries.

Section 5.3 Subsidiaries; Investments. Except as set forth in Section 5.3 of the PNT Disclosure Schedule, as of the date of this Agreement, PNT has no Subsidiaries or investments in any Person (except for marketable securities disclosed to SUG) and, except for the issued and outstanding PG Preferred Stock, PNT is the registered owner and holder of all of the issued and outstanding shares of capital stock of its Subsidiaries and has good title to such shares. The outstanding capital stock of each material Subsidiary has been validly issued and is fully paid and nonassessable. All such capital stock owned by any Acquired Company is free and clear of any Encumbrance (except for any Encumbrance disclosed in the PNT SEC Documents filed to date, or created or incurred by this Agreement in favor of SUG, or imposed by federal or state securities laws).

Section 5.4 Authority Relative to this Agreement and Binding Effect. The execution, delivery and performance of this Agreement and the Related Documents by PNT have been duly authorized by all requisite corporate action, except, as of the date of this Agreement, for the PNT Shareholders' Approval, the approval of the Boards of Directors of PG Energy and Honesdale of the transactions contemplated hereby and the approval of the holders of common stock of each of PG Energy and Honesdale of the transactions contemplated hereby. Except as set forth in the schedule to be delivered by PNT to SUG within seven days of the date of this Agreement, the execution, delivery and performance of this Agreement and the Related Documents by PNT will not result in a violation or breach of any term or provision of, or constitute a default or accelerate the performance required under, the Organizational Documents of any of the Acquired Companies, any indenture, mortgage, deed of trust, security agreement, loan agreement, or Material Contract to which any of the Acquired Companies is a party or by which its assets are bound, or violate any order, writ, injunction or decree of any Governmental Body, with such exceptions as are not, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect. This Agreement constitutes and the Related Documents to be

executed by any of the Acquired Companies when executed and delivered will constitute valid and binding obligations of such Acquired Company, enforceable against such Acquired Company in accordance with their terms, except as enforceability may be limited by (i) bankruptcy or similar laws from time to time in effect affecting the enforcement of creditors' rights generally or (ii) the availability of equitable remedies generally.

Section 5.5 Governmental Approvals. Except as set forth in Section 5.5 of the PNT Disclosure Schedule and as required by the HSR Act, no approval or authorization of any Governmental Body with respect to performance under this Agreement by any Acquired Company is required to be obtained by PNT in connection with the execution and delivery by PNT of this Agreement or the consummation by the Acquired Companies of the transactions contemplated by this Agreement, the failure to obtain which are, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect.

Section 5.6 Public Utility Holding Company Status; Regulation as a Public Utility. PNT is a "holding company" (as such term is defined in PUHCA) exempt from certain provisions of PUHCA, and has received no adverse notice from the SEC with respect to the validity of its exempt status, pursuant to Section 3(a)(1) of PUHCA. PG Energy is a "public utility company" (as such term is defined in PUHCA). Honesdale is a "public utility company" (as such term is defined in PUHCA). Each of PG Energy and Honesdale is a "subsidiary company" of PNT, and an "affiliate" of the other and of PNT (as such terms are defined in PUHCA). Except as stated above in this Section 5.6, none of the Acquired Companies is a "holding company," a "subsidiary company," a "public utility company," or an "affiliate" of a "public utility company" or a "holding company" within the meaning of such terms in PUHCA.

Section 5.7 Compliance with Legal Requirements; Governmental Authorizations.

(a) Except as set forth in Section 5.7(a) of the PNT Disclosure Schedule or as specifically described in the PNT SEC Documents delivered to SUG prior to the date of this Agreement, and subject to Section 5.19 of this Agreement, to the Knowledge of any Acquired Company, no Acquired Company is in violation of any Legal Requirement that is applicable to it, to the conduct or operation of its business, or to the ownership or use of any of its assets, other than such violations, if any, which are not, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect.

(b) The PNT SEC Documents delivered to SUG prior to the date of this Agreement accurately describe all material regulation of each Acquired Company that relates to the utility business of any Acquired Company. Except as set forth on Section 5.7(a) of the PNT Disclosure Schedule, each Acquired Company has and is in material compliance with all material Governmental Authorizations necessary to conduct its business and to own, operate and use all of its assets as currently conducted.

Section 5.8 Legal Proceedings; Orders. Except as set forth in Section 5.8 of the PNT Disclosure Schedule or as specifically described in the PNT SEC Documents delivered to SUG prior to the date of this Agreement, there is no pending Proceeding:

(1) that has been commenced by or against, or that otherwise relates to, any Acquired Company that is reasonably likely to have a PNT Material Adverse Effect; or

(2) as of the date of this Agreement, that challenges, or that may have the effect of preventing, delaying, making illegal, or otherwise interfering with, the Mergers or any of the transactions contemplated hereby.

To the Knowledge of PNT, except as set forth in Section 5.8 of the PNT Disclosure Schedule, as of the date of this Agreement, no such Proceedings, audits or investigations have been Threatened that are, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect.

Section 5.9 SEC Documents. PNT has made (and, with respect to such documents filed after the date hereof through the Closing Date, will make) available to SUG a true and complete copy of each report, schedule, registration statement (other than on Form S-8), and definitive proxy statement filed by PNT or PG Energy with the SEC since December 31, 1998 through the Closing Date in substantially the form filed with the SEC (the "PNT SEC Documents"). As of their respective dates, the PNT SEC Documents, including without limitation any financial statements or schedules included therein, complied (or will comply), in all material respects with the requirements of the Securities Act or the Exchange Act, as the case may be, and the rules and regulations of the SEC thereunder applicable to such PNT SEC Documents, and did not (or will not) contain any untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made, not misleading. The audited consolidated financial statements and unaudited interim financial statements of PNT or PG Energy included in the PNT SEC Documents (collectively, the "PNT Financial Statements") were (or will be) prepared in accordance with GAAP (except as may be indicated therein or in the notes thereto and except with respect to unaudited statements as permitted by Form 10-Q) and fairly present (or will fairly present) in all material respects the financial position of PNT and its Subsidiaries, or PG Energy, as the case may be, as of the respective dates thereof or the results of operations and cash flows for the respective periods then ended, as the case may be, subject, in the case of unaudited interim financial statements, to normal, recurring adjustments which are not material in the aggregate.

Section 5.10 Taxes.

(a) The Acquired Companies have timely filed all United States federal, state and local income Tax Returns required to be filed by or with respect to them or requests for extensions to file such Tax Returns have been timely filed, granted and have not expired, and the Acquired Companies have timely paid and discharged all Taxes due in connection with or with respect to the periods or transactions covered by such Tax Returns and have paid all other Taxes as are due or made adequate provision therefor in accordance with GAAP except where failures to so file, pay or discharge are not, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect. There are no pending audits or other examinations relating to any Tax matters. There are no Tax liens on any assets of the Acquired Companies. As of the date

of this Agreement, none of the Acquired Companies has granted any waiver of any statute of limitations with respect to, or any extension of a period for the assessment of, any Tax. The accruals and reserves (including deferred taxes) reflected in the PNT Balance Sheet are in all material respects adequate to cover all material Taxes accruable through the date thereof (including interest and penalties, if any, thereon and Taxes being contested) in accordance with GAAP. Prior to the date of this Agreement, no Acquired Company has at any time adopted a plan of complete liquidation within the meaning of Section 332 of the IRC.

(b) None of the Acquired Companies is obligated under any Contract with respect to industrial development bonds or other obligations with respect to which the excludability from gross income of the holder for federal or state income tax purposes could be affected by the Merger or any of the transactions contemplated by this Agreement.

Section 5.11 Intellectual Property. Except as set forth in Section 5.11 of the PNT Disclosure Schedule, no Acquired Company has any Knowledge of (i) any infringement or claimed infringement by it of any patent rights or copyrights of others or (ii) any infringement of the patent or patent license rights, trademarks or copyrights owned by or under license to it, except for any such infringements of the type described in clause (i) or (ii) that are not, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect.

Section 5.12 Title to Assets. Except (i) as set forth in Section 5.12 of the PNT Disclosure Schedule, (ii) as specifically described in the PNT SEC Documents delivered to SUG prior to the date of this Agreement, (iii) as set forth in Section 5.19 of this Agreement or (iv) as set forth in Section 5.19 of the PNT Disclosure Schedule, none of the Acquired Companies' assets are subject to any Encumbrance other than PNT Permitted Liens.

Section 5.13 Indebtedness. All outstanding principal amounts of indebtedness for borrowed money of the Acquired Companies as of June 4, 1999 are set forth in Section 5.13 of the PNT Disclosure Schedule, except for inter-company indebtedness.

Section 5.14 Machinery and Equipment. Except for normal wear and tear, and with such exceptions as are not, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect, the machinery and equipment of the Acquired Companies is in good operating condition and in a state of reasonable maintenance and repair.

Section 5.15 Material Contracts. Except as specifically described in the PNT SEC Documents delivered to SUG prior to the date of this Agreement, and with such exceptions as are not, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect, all Material Contracts of the Acquired Companies are in full force and effect and no Acquired Company nor, to the Knowledge of PNT, any other party thereto is in default thereunder nor has any event occurred or is any event occurring that with notice or the passage of time or otherwise, is reasonably likely to give rise to an event of default thereunder by any party thereto.

Section 5.16 Insurance. Section 5.16(a) of the PNT Disclosure Schedule sets forth a list of all policies of insurance held by the Acquired Companies as of the date of this Agreement.

Except as set forth in Section 5.16(b) of the PNT Disclosure Schedule, since June 30, 1994, the assets and the business of the Acquired Companies have been continuously insured with what PNT reasonably believes are reputable insurers against all risks and in such amounts normally insured against by companies of the same type and in the same line of business as any of the Acquired Companies. As of the date of this Agreement, no notice of cancellation, non-renewal or material increase in premiums has been received by any of the Acquired Companies with respect to such policies, and no Acquired Company has Knowledge of any fact or circumstance that could reasonably be expected to form the basis for any cancellation, non-renewal or material increase in premiums, except for such cancellations, non-renewals and increases which are not, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect. None of the Acquired Companies is in default with respect to any provision contained in any such policy or binder nor has there been any failure to give notice or to present any claim relating to the business or the assets of the Acquired Companies under any such policy or binder in a timely fashion or in the manner or detail required by the policy or binder, except for such defaults or failures which are not, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect. As of the date of this Agreement, there are no outstanding unpaid premiums (except premiums not yet due and payable), and no notice of cancellation or renewal with respect to, or disallowance of any claim under, any such policy or binder has been received by the Acquired Companies as of the date hereof, except for such non-payments of premiums, cancellations, renewals or disallowances which are not, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect

Section 5.17 Employees. Section 5.17(a) of the PNT Disclosure Schedule sets forth a list as of no more than thirty (30) days prior to the date of this Agreement of all the present officers and employees of the Acquired Companies. Except as set forth in Section 5.17(b) of the PNT Disclosure Schedule, as of the date of this Agreement, no labor union or other collective bargaining unit has been certified or recognized by any of the Acquired Companies, and, to the Knowledge of the Acquired Companies, as of the date of this Agreement, there are no elections, organizing drives or material controversies pending or Threatened between any of the Acquired Companies and any labor union or other collective bargaining unit representing any of the Acquired Companies' employees. There is no pending or, to the Knowledge of PNT, Threatened labor practice complaint, arbitration, labor strike or other material labor dispute (excluding grievances) involving any of the Acquired Companies which are, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect. Except for collective bargaining agreements or as described in or pursuant to Section 5.18 and Section 6.1(a)(16) or as attached as an exhibit to, or as specifically described in, the PNT SEC Documents delivered to SUG prior to the date of this Agreement, as of the date of this Agreement, to the Knowledge of PNT, none of the Acquired Companies is a party to any employment agreement with any employee pertaining to any of the Acquired Companies.

Section 5.18 Employee Benefit Plans.

(a) Except as set forth in Section 5.18 of the PNT Disclosure Schedule, each of the PNT Benefit Plans has been operated and administered in all material respects in accordance with its governing documents and applicable federal and state laws (including, but not limited to,

ERISA and the IRC). For purposes of this Agreement, "PNT Benefit Plans" shall mean all employee retirement, welfare or other benefit plans, agreements, practices, policies, programs, or arrangements identified and described in Section 5.18 of the PNT Disclosure Schedule, which sets forth all PNT Benefit Plans that are applicable to any employee of the Acquired Companies identified in Section 5.17 of the PNT Disclosure Schedule or maintained by or contributed to by any of the Acquired Companies.

(b) Except as set forth in Section 5.18 of the PNT Disclosure Schedule, as to any PNT Benefit Plan subject to Title IV of ERISA, there is no event or condition which presents the material risk of plan termination, no accumulated funding deficiency, whether or not waived, within the meaning of Section 302 of ERISA or Section 412 of the IRC has been incurred for which any liability is outstanding, no reportable event within the meaning of Section 4043 of ERISA (for which the notice requirements of Regulation §4043 promulgated by the PBGC have not been waived) has occurred within the last six years, no notice of intent to terminate the PNT Benefit Plan has been given under Section 4041 of ERISA, no proceeding has been instituted under Section 4042 of ERISA to terminate the PNT Benefit Plan, there has been no termination or partial termination of the PNT Benefit Plan within the meaning of Section 411(d)(3) of the IRC within the last six years, no event described in Sections 4062 or 4063 of ERISA has occurred, all PBGC premiums have been timely paid and no liability to the PBGC has been incurred, except for PBGC premiums not yet due.

(c) There is no matter pending (other than qualification determination applications and filings and other required periodic filings) with respect to any of the PNT Benefit Plans before the IRS, the Department of Labor, the PBGC or in or before any other governmental authority.

(d) Except as set forth in Section 5.18 of the PNT Disclosure Schedule, each trust funding a PNT Benefit Plan, which trust is intended to be exempt from federal income taxation pursuant to Section 501(c)(9) of the IRC, satisfies the requirements of such section and has received a favorable determination letter from the IRS regarding such exempt status and to the Knowledge of any Acquired Company has not, since receipt of the most recent favorable determination letter, been amended or operated in any way which would adversely affect such exempt status.

(e) Except as otherwise set forth in Section 5.18 of the PNT Disclosure Schedule, with respect to any PNT Benefit Plan or any other "employee benefit plan" as defined in Section 3(3) of ERISA which is established, sponsored, maintained or contributed to, or to the Knowledge of the Acquired Companies, with respect to any such plan which has been established, sponsored, maintained or contributed to within six years prior to the Closing Date, by the Acquired Companies or any corporation, trade, business or entity under common control or being a part of an affiliated service group with any of the Acquired Companies, within the meaning of Section 414(b), (c) or (m) of the IRC or Section 4001 of ERISA ("PNT Commonly Controlled Entity"), (i) no withdrawal liability, within the meaning of Section 4201 of ERISA, has been incurred, which withdrawal liability has not been satisfied and no such withdrawal liability is reasonably expected to be incurred, (ii) no liability under Title IV of ERISA (including, but not

limited to, liability to the PBGC) has been incurred by the Acquired Companies or any PNT Commonly Controlled Entity, which liability has not been satisfied (other than for PBGC premiums not yet due), (iii) no accumulated funding deficiency, whether or not waived, within the meaning of Section 302 of ERISA or Section 412 of the IRC has been incurred for which any liability is outstanding, (iv) there has been no failure to make any contribution (including installments) to such plan required by Section 302 of ERISA and Section 412 of the IRC which has resulted in a lien under Section 302 of ERISA or Section 412 of the IRC and for which any liability is currently outstanding; (v) to the Knowledge of any Acquired Company, no action, omission or transaction has occurred with respect to any such plan or any other PNT Benefit Plan which could subject any of the Acquired Companies, the plan or trust forming a part thereof, or SUG to a material civil liability or penalty under ERISA or other applicable laws, or a material Tax under the IRC, (vi) any such plan which is a Group Health Plan has complied in all material respects with the provisions of Sections 601-608 of ERISA and Section 4980B of the IRC, (vii) there are no pending or, to the Knowledge of any of the Acquired Companies, Threatened claims by or on behalf of any such plan or any other PNT Benefit Plan, by any employees, former employees or plan beneficiaries covered by such plan or otherwise by or on behalf of any person involving any such plan (other than routine non-contested claims for benefits) which could result in a material liability to the Acquired Companies taken as a whole and (viii) neither the Acquired Companies nor any PNT Commonly Controlled Entity has engaged in, or is a successor or parent corporation to any entity or person that has engaged in, a transaction described in Section 4069 of ERISA.

(f) Except as otherwise set forth in Section 5.18 of the PNT Disclosure Schedule, the execution and delivery of this Agreement and the consummation of the transactions contemplated hereby will not (i) require SUG to make a later contribution to, payment or transfer of money or property or payment of greater benefits under or with respect to any PNT Benefit Plan than any of the Acquired Companies is currently required by the terms and provisions of such PNT Benefit Plan to do, (ii) create or give rise to any additional eligibility for participation, vested rights benefits or service credits under any PNT Benefit Plan, or (iii) in and of themselves cause or result in SUG incurring any civil liability or penalty under ERISA or other applicable laws or Tax under the IRC.

(g) Except as otherwise set forth in Section 5.18 of the PNT Disclosure Schedule, none of the Acquired Companies is a party to any Contract nor has it established any policy or practice, which would require it or SUG to make a payment or provide any other form of compensation or benefit to any Person performing (or who within the past twelve months performed) services for any of the Acquired Companies during or upon termination of such services which would not be payable or provided in the absence of the consummation of the transactions contemplated by this Agreement.

(h) Except as would affect retirees and unionized employees and as otherwise set forth in Section 5.18 of the PNT Disclosure Schedule, each PNT Benefit Plan which is an "employee welfare benefit plan," as such term is defined in Section 3(1) of ERISA, may be unilaterally amended or terminated in its entirety without any liability being incurred by any of

the Acquired Companies, SUG or any affiliate of SUG, except as to benefits accrued thereunder prior to such amendment or termination.

(i) Section 5.18 of the PNT Disclosure Schedule contains a true and complete list as of the date of this Agreement of each PNT Benefit Plan, all Acquired Company Option Plans and any management, employment, deferred compensation, severance (including any payment, right or benefit resulting from a change in control), bonus or other contract for personal services with any current or former officer, director or employee, any consulting contract with any person who prior to entering this such contract was a director or officer of any Acquired Company or any plan, agreement, arrangement or understanding similar to any of the foregoing.

(j) None of the Acquired Companies has contributed nor been obligated to contribute to any "multi-employer plan" within the meaning of Section 3(37) of ERISA within the last six years, and none of the Acquired Companies has any outstanding liability with respect to any such plan.

Section 5.19 Environmental Matters. Except as set forth in Section 5.19 of the PNT Disclosure Schedule or as specifically described in the PNT SEC Documents delivered to SUG prior to the date of this Agreement, and with such other exceptions as are not, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect:

(a) To the Knowledge of any Acquired Company, no Facility owned or operated by any Acquired Company is currently, or was at any time, listed on the National Priorities List promulgated under CERCLA, or on any comparable state list, and no Acquired Company has received any written notification of potential or actual liability or a written request for information from any Person under or relating to CERCLA or any comparable Legal Requirement with respect to any Acquired Company or the Facilities;

(b) To the Knowledge of any Acquired Company, each Acquired Company and any Person for whose conduct any Acquired Company is reasonably likely to be held responsible, and at all times has been, in material compliance with any Environmental Law. No Acquired Company has received any Order, notice, or other communication from (i) any Governmental Body or private citizen acting in the public interest, or (ii) the current or prior owner or operator of any Facilities, of any violation or failure to comply with any Environmental Law, or of any obligation to undertake or bear the cost of any environmental cleanup, or with respect to any property or Facility at which Hazardous Materials generated by any Acquired Company were transported for disposal;

(c) There are no pending or, to the Knowledge of any of the Acquired Companies, Threatened claims arising under or pursuant to any Environmental Law with respect to or affecting any of the Facilities or any other properties and assets (whether real, personal, or mixed) in which any Acquired Company has or had a direct or indirect interest (including by ownership or use); and

(d) PNT has delivered or made available to SUG true and complete copies and results of any environmental site assessments, studies, analyses, tests or monitoring possessed by any Acquired Company of which any Acquired Company has Knowledge pertaining to Hazardous Materials or Hazardous Activities in, on or under the Facilities, or concerning compliance by any Acquired Company or any other Person for whose conduct any Acquired Company is reasonably likely to be held responsible, with Environmental Laws.

Section 5.20 No Material Adverse Change. Since the date of the PNT Balance Sheet, except as specifically described in the PNT SEC Documents delivered to SUG prior to the date of this Agreement, there has not been any PNT Material Adverse Effect, and no events have occurred or circumstances exist that are, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect, except that any PNT Material Adverse Effect that results from or relates to (a) general business or economic conditions, (b) conditions generally affecting the industries in which the Acquired Companies compete or (c) the announcement of the transactions contemplated by this Agreement shall be disregarded.

Section 5.21 Brokers. No Acquired Company is a party to, or in any way obligated under any Contract, and there are no outstanding claims against any Acquired Company, for the payment of any broker's or finder's fees in connection with the origin, negotiation, execution or performance of this Agreement.

Section 5.22 PNT Rights Agreement. Prior hereto, PNT has delivered to SUG a true and complete copy of the PNT Rights Agreement. The consummation of the transactions contemplated by this Agreement will not result in the triggering of any right or entitlement of the holders of the PNT Common Stock or other PNT securities under the PNT Rights Agreement or any similar agreement to which PNT or any of its Subsidiaries is a party.

Section 5.23 Regulatory Proceedings. Except as set forth in Section 5.23 of the PNT Disclosure Schedule, other than purchase gas adjustment provisions, none of PNT or its Subsidiaries all or part of whose rates or services are regulated by a Governmental Body (a) has rates that have been or are being collected subject to refund, pending final resolution of any rate proceeding pending before a Governmental Body or on appeal to the courts, or (b) is a party to any rate proceeding before a Governmental Body that are, individually or in the aggregate, reasonably likely to result in any Orders having a PNT Material Adverse Effect.

Section 5.24 Proxy Statement; Registration Statement. None of the information supplied or to be supplied by or on behalf of PNT and its Subsidiaries in either the PNT Proxy Statement or supplied or to be supplied by PNT to SUG for inclusion in either the SUG Proxy Statement or the Registration Statement, will, with respect to the Registration Statement, at the effective time of the Registration Statement, at any time the Registration Statement is amended or supplemented, at the date the PNT Proxy Statement is first mailed to PNT's shareholders, at any time the PNT Proxy Statement is amended or supplemented, at the time of the PNT Meeting and at the Effective Time, in the case of the PNT Proxy Statement, at the date the PNT Proxy Statement is first mailed to PNT's shareholders, at any time the PNT Proxy Statement is amended or supplemented and at the time of the PNT Meeting and in the case of the SUG Proxy Statement,

at the date the SUG Proxy Statement is first mailed to SUG's shareholders, at any time the SUG Proxy Statement is amended or supplemented and at the time of the SUG Meeting (giving effect to any documents incorporated by reference therein), contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary in order to make the statements therein, in light of the circumstances under which they are made, not misleading. The PNT Proxy Statement will comply as to form and in substance in all material respects with the applicable provisions of the Exchange Act and the rules and regulations thereunder.

Section 5.25 Vote Required. Other than the approval of the Merger by the holders of a majority of the outstanding shares of PNT Common Stock (the "PNT Shareholders' Approval") and the approval by the holders of common stock of each of PG Energy and Honesdale, no vote of the holders of any class or series of the capital stock of any Acquired Company is required to approve this Agreement and the Mergers.

Section 5.26 Opinion of Financial Advisor. PNT has provided (or promptly upon receipt of a written copy thereof, will provide) SUG a copy of the opinion of Legg Mason Wood Walker, Incorporated, dated as of the date hereof, with respect to the Merger Consideration to be received by the holders of PNT Common Stock pursuant to the transactions contemplated by this Agreement.

Section 5.27 Disclaimer of Representations and Warranties. EXCEPT FOR THE REPRESENTATIONS AND WARRANTIES CONTAINED IN THIS ARTICLE V, PNT MAKES NO OTHER REPRESENTATIONS OR WARRANTIES, EXPRESS OR IMPLIED, AND PNT HEREBY DISCLAIMS ANY SUCH OTHER REPRESENTATIONS OR WARRANTIES, WHETHER BY PNT, ANY SUBSIDIARY OF PNT, OR ANY OF THEIR RESPECTIVE OFFICERS, DIRECTORS, EMPLOYEES, AGENTS OR REPRESENTATIVES, OR ANY OTHER PERSON, WITH RESPECT TO THIS AGREEMENT AND THE TRANSACTIONS CONTEMPLATED HEREBY, NOTWITHSTANDING THE DELIVERY OR DISCLOSURE TO SUG OR ANY OF ITS DIRECTORS, OFFICERS, EMPLOYEES, AGENTS OR REPRESENTATIVES, OR ANY OTHER PERSON, OF ANY DOCUMENTATION OR OTHER INFORMATION BY PNT, ANY SUBSIDIARY OF PNT, OR ANY OF THEIR RESPECTIVE DIRECTORS, OFFICERS, EMPLOYEES, AGENTS OR REPRESENTATIVES, OR ANY OTHER PERSON, WITH RESPECT TO ANY OF THE FOREGOING.

ARTICLE VI COVENANTS

Section 6.1 Covenants of PNT. PNT agrees to observe and perform the following covenants and agreements:

(a) Conduct of the Business Prior to the Closing Date. With respect to the Acquired Companies, except (i) as contemplated in this Agreement, (ii) for a sale by PNT of Keystone Pipeline Services, Inc. or by Keystone Pipeline Services, Inc. of its assets, or the sale by any of the Acquired Companies of any real property owned by any of them that is not used or useful in the Acquired Companies' utility operations, (iii) the redemption or repurchase of the PG

Preferred Stock prior to the Effective Time, (iv) as required by law or regulation or (v) as otherwise expressly consented to in writing by SUG which consent will not be unreasonably withheld or delayed, prior to the Closing, PNT will cause each Acquired Company to:

(1) Not make or permit any material change in the general nature of its business;

(2) Maintain its Ordinary Course of Business in accordance with prudent business judgment and consistent with past practice and policy, and maintain its assets in good repair, order and condition, reasonable wear and tear excepted, subject to retirements in the Ordinary Course of Business;

(3) Preserve the Acquired Company as an ongoing business and use reasonable efforts to maintain the goodwill associated with the Acquired Company;

(4) Preserve all of the Acquired Companies' franchises, tariffs, certificates of public convenience and necessity, licenses, authorizations and other governmental rights and permits;

(5) Not enter into any material transaction or Material Contract other than in the Ordinary Course of Business;

(6) Not purchase, sell, lease, dispose of or otherwise transfer or make any contract for the purchase, sale, lease, disposition or transfer of, or subject to lien, any of the assets of the Acquired Company other than in the Ordinary Course of Business;

(7) Not hire any new employee unless such employee is a bona fide replacement for a presently-filled position with the Acquired Company as of the date hereof except for no more than ten (10) new employees to be hired by PG Energy Services, Inc. for the conduct of the electric and natural gas marketing business;

(8) Not file any material applications, petitions, motions, orders, briefs, settlement or agreements in any material Proceeding before any Governmental Body which involves the Acquired Company, and appeals related thereto without, to the extent reasonably practicable, consulting SUG; provided, however, that if such Proceeding is reasonably likely to have a PNT Material Adverse Effect, PNT shall not make any such filing without the consent of SUG, which consent shall not be unreasonably withheld or delayed.

(9) Not engage in any new (other than intercompany short-term financing arrangements in the Ordinary Course of Business), or modify any existing, intercompany transactions involving Keystone Pipeline Services, Inc., and not engage in or modify, except in the Ordinary Course of Business, any material intercompany transactions involving any other Acquired Company, except as set forth in Section 6.1(a)(9) of the PNT Disclosure Schedule;

(10) Not voluntarily change in any material respect or terminate any insurance policies disclosed on Section 5.16(a) of the PNT Disclosure Schedule that presently are in effect unless equivalent coverage is obtained;

(11) Except as disclosed or specifically contemplated in this Agreement or in Section 6.1(a)(11) of the PNT Disclosure Schedule, and with respect to budgeted expenditures known and specifically disclosed in writing to SUG, subject to adjustments in the Ordinary Course of Business and other deviations (which in the aggregate shall not exceed 5% on an annualized basis during the period from the date of this Agreement until the Closing Date), not make any capital expenditure or capital expenditure commitment;

(12) Not make any changes in financial policies or practices, or strategic or operating policies or practices, in each case which involve any Acquired Company, except as required by law, rule or regulation;

(13) Comply in all material respects with all applicable material Legal Requirements and permits, including without limitation those relating to the filing of reports and the payment of Taxes due to be paid prior to the Closing, other than those contested in good faith;

(14) Not adopt, amend (other than amendments that reduce the amounts payable by SUG or any of its subsidiaries or amendments required by law) or assume an obligation to contribute to any PNT Benefit Plan or collective bargaining agreement or enter into any employment, severance or similar contract with any Person (including without limitation, contracts with management of any Acquired Company or any of its affiliates that might require payments be made upon consummation of the transactions contemplated hereby) or amend any such existing contracts to increase any amounts payable thereunder or benefits provided thereunder;

(15) Except in the Ordinary Course of Business or in accordance with the terms of any existing Contract, PNT Benefit Plan or collective bargaining agreement, not grant any increase or change in total compensation, benefits or pay any bonus to any employees;

(16) Not grant or enter into any Contract, written or oral, with respect to continued employment for any employee, officer or director;

(17) Not make (i) any loan or advance to any officer, director, stockholder or employee other than in the Ordinary Course of Business or (ii) make any other loan or advance to any Person other than in the Ordinary Course of Business;

(18) Not terminate any existing gas purchase, exchange or transportation contract necessary to supply firm gas at all city gate delivery points or enter into any new contract for the supply, transportation, storage or exchange of gas with respect to the Acquired Companies' regulated gas distribution operations or renew or extend or negotiate

any existing contract providing for the same where such contract is not terminable within sixty (60) days without penalty unless specifically agreed to by SUG;

(19) Not amend any of its Organizational Documents; and

(20) Subject to Section 6.1(l), not issue or assume any note, debenture or other evidence of indebtedness which by its terms does not mature within two year(s) (except that PG Energy shall have no more than \$11,999,999 of indebtedness which matures within one year from the date of any such issuance or assumption) from the date of execution or issuance thereof, unless otherwise redeemable or subject to prepayment at any time at the option of the Acquired Company on not more than thirty (30) days notice without penalty for such redemption or prepayment.

(b) Customer Notifications. At any time and from time to time reasonably requested by SUG prior to the Closing Date, each Acquired Company will permit SUG at SUG's expense to insert preprinted single-page customer education materials into billing documentation to be delivered to customers affected by this Agreement; provided that, PNT has reviewed in advance and consented to the content of such materials, which consent shall not be unreasonably withheld. Other means of notifying customers may be employed by either party, at the expense of the initiating party, but in no event shall any notification be initiated without the prior consent of the other party (which consent shall not be unreasonably withheld).

(c) Access to the Acquired Companies' Offices, Properties and Records; Updating Information.

(1) From and after the date hereof and until the Closing Date, the Acquired Companies shall permit SUG and its Representatives to have, on reasonable notice and at reasonable times, reasonable access to such of the offices, properties and employees of the Acquired Companies, and shall disclose, and make available to SUG and its Representatives all books, papers and records to the extent that they relate to the ownership, operation, obligations and liabilities of or pertaining to the Acquired Companies and their businesses and assets. Without limiting the application of the Confidentiality Agreement dated May 10, 1999 between PNT and SUG (the "Confidentiality Agreement"), all documents or information furnished by the Acquired Companies hereunder shall be subject to the Confidentiality Agreement.

(2) PNT will notify SUG as promptly as practicable of any significant change in the Ordinary Course of Business or operation of any of the Acquired Companies and of any material complaints, investigations or hearings (or communications indicating that the same may be contemplated) by any Governmental Body, or the institution or overt threat or settlement of any material Proceeding involving or affecting any of the Acquired Companies or the transactions contemplated by this Agreement, and shall use reasonable efforts to keep SUG fully informed of such events and permit SUG's Representatives access to all materials prepared in connection therewith, consistent with any applicable Legal Requirement or Contract.

(3) As promptly as practicable after SUG's request, PNT will furnish such financial and operating data and other information pertaining to the Acquired Companies and their businesses and assets as SUG may reasonably request; provided, however, that nothing herein will obligate any of the Acquired Companies to take actions that would unreasonably disrupt its Ordinary Course of Business or violate the terms of any Legal Requirement or Contract to which the Acquired Company is a party or to which any of its assets is subject in providing such information, or to incur any costs with respect to SUG's external auditors (or the Acquired Companies' external auditors in the event a report by such auditors is requested by SUG) providing accounting services with respect to issuing an auditor's report required by or for SUG.

(d) Governmental Approvals; Third Party Consents. PNT will use its reasonable best efforts to obtain all necessary consents, approvals and waivers from any Person required under any license, lease, permit or Contract applicable to the Acquired Companies, including, without limitation, the approvals of those Governmental Bodies and the consents of those third parties listed in Section 5.4 and Section 5.5 of the PNT Disclosure Schedule and as required by the HSR Act.

(e) Dividends. PNT shall not, nor shall it permit any of its Subsidiaries to: (i) declare or pay any dividends on or make other distributions in respect of any of its or their capital stock other than (A) dividends by a wholly owned Subsidiary to PNT or another wholly owned subsidiary, (B) dividends by a less than wholly owned Subsidiary consistent with past practice, (C) regular quarterly dividends on PNT Common Stock with usual record and payment dates that do not exceed the current rate of \$1.20 per fiscal year, or (D) regular cumulative cash distributions on the 4.10% PG Preferred Stock not to exceed an annual rate of \$4.10 per share or on the 5.75% PG Preferred Stock not to exceed an annual rate of \$5.75 per share; (ii) split, combine or reclassify any capital stock or the capital stock of any Subsidiary or issue or authorize or propose the issuance of any other securities in respect of, or in substitution for, shares of capital stock or the capital stock of any Subsidiary; or (iii) redeem, repurchase or otherwise acquire any shares of capital stock of any Subsidiary other than (A) redemptions, repurchases and other acquisitions of shares of capital stock in connection with the administration of employee benefit and dividend reinvestment and customer stock purchase plans as in effect on the date hereof in the ordinary course of the operation of such plans consistent with past practice, (B) intercompany acquisitions of capital stock, (C) required redemptions of the 5.75% PG Preferred Stock, (D) the redemption or repurchase of the PG Preferred Stock as contemplated herein or (E) as set forth in Section 6.1(l) of this Agreement.

(f) Issuance of Securities. PNT shall not, nor shall it permit any of its Subsidiaries to, issue, agree to issue, deliver, sell, award, pledge, dispose of or otherwise encumber or authorize or propose the issuance, delivery, sale, award, pledge, disposal or other encumbrance of, any shares of its or their capital stock of any class or any securities convertible into or exchangeable for, or any rights, warrants or options to acquire, any such shares or convertible or exchangeable securities, other than as provided for in the PNT Benefit Plans, Acquired Company Option Plans (including options to be granted to directors of PNT pursuant

to such PNT Benefit Plans and Acquired Company Option Plans) and any dividend reinvestment or customer stock purchase plans of PNT in effect as of the date hereof.

(g) Accounting. PNT shall not, nor shall it permit any of its Subsidiaries to, make any changes in their accounting methods, principles or practices except as required by law, rule, regulation or GAAP.

(h) No Shopping.

(1) PNT shall not, and shall not authorize or permit any of its (or any of its Subsidiaries') officers, directors, agents, financial advisors, attorneys, accountants or other representatives to, directly or indirectly, solicit, initiate or encourage submission of proposals or offers from any Person relating to, or that could reasonably be expected to lead to, a Business Combination or participate in any negotiations or discussions regarding, or furnish to any other Person any information with respect to, or otherwise cooperate in any way with, or assist or participate in, facilitate or encourage, any effort or attempt by any other Person to do or seek a Business Combination; provided, however, that, prior to the PNT Shareholders' Approval, PNT may, in response to an unsolicited written proposal from a third party with respect to a Business Combination that PNT's Board of Directors determines, in its good faith judgment, after consultation with and the receipt of the advice of its financial advisor and outside counsel with customary qualifications, is a Superior Proposal, (i) furnish information to, and negotiate, explore or otherwise engage in substantive discussions with such third party, only if PNT's Board of Directors determines, in its good faith judgment after consultation with its financial advisors and outside legal counsel, that it is reasonably necessary in order to comply with its fiduciary duties under applicable law and (ii) take and disclose to PNT's shareholders a position with respect to another Business Combination proposal, or amend or withdraw such position, pursuant to Rule 14d-9 and 14e-2 under the Exchange Act, or make such disclosure to PNT's shareholders which in the good faith judgment of PNT's Board of Directors is required by applicable law, based on the advice of its outside counsel. Prior to furnishing any non-public information to, entering into negotiations with or accepting a Superior Proposal from such third party, PNT will (i) provide written notice to SUG to the effect that it is furnishing information to or entering into discussions or negotiations with such third party and (ii) receive from such third party an executed confidentiality agreement containing substantially the same terms and conditions as the Confidentiality Agreement. PNT will immediately cease and cause to be terminated any existing solicitation, initiation, encouragement, activity, discussion or negotiations with any parties conducted heretofore by PNT or any of its representatives with respect to any Business Combination.

(2) Except as expressly permitted by this Section 6.1(h), neither the PNT Board of Directors nor any committee thereof may, (i) withdraw or modify, or propose publicly to withdraw or modify, in a manner adverse to SUG, the approval or recommendation by such Board of Directors or such committee of the Merger or this Agreement, (ii) approve or recommend, or propose publicly to approve or recommend,

a Business Combination or (iii) cause PNT to enter into any letter of intent, agreement in principle, acquisition agreement or other similar agreement related to any Business Combination. Notwithstanding the foregoing, prior to the time at which the PNT Shareholders' Approval has been obtained, in response to an unsolicited Business Combination proposal from a third party, if PNT's Board of Directors determines, in its good faith judgment, after consultation with and the receipt of the advice of its financial advisor and outside counsel with customary qualifications, that such proposal is a Superior Proposal and that failure to do any of the actions set forth in clauses (i), (ii) or (iii) above would create a reasonable possibility of a breach of the fiduciary duties of PNT's Board of Directors under applicable law, PNT's Board of Directors may (i) withdraw or modify its approval or recommendation of the Merger or this Agreement, approve or recommend a Business Combination or cause PNT to enter into a Business Combination and (ii) negotiate with a third party with respect to such Business Combination proposal and, subject to PNT having paid to SUG the fees described in Section 8.3(a) hereof and having entered into a definitive agreement with respect to such Business Combination proposal, terminate this Agreement; provided, however, that prior to entering into a definitive agreement with respect to a Business Combination proposal, the Company shall give SUG at least five (5) day's notice thereof, and shall cause its representatives to, negotiate with SUG to make such adjustments in the terms and conditions of this Agreement as would enable PNT to proceed with the transactions contemplated herein on such adjusted terms; provided, further, that if PNT and SUG are unable to reach an agreement on such adjustments within five (5) days after such notice from PNT, PNT may enter into such definitive agreement, subject to the provisions of Article VIII.

(3) PNT shall notify SUG orally and in writing of any such inquiries, offers or proposals (including, without limitation, the material terms and conditions of any such offer or proposal and the identity of the Person making it), within one business day of the receipt thereof, shall use all reasonable efforts to keep SUG informed of the status and details of any such inquiry, offer or proposal and shall give SUG two (2) day's advance notice of the first delivery of non-public information to such Person. If any such inquiry, offer or proposal is in writing, PNT shall promptly deliver to SUG a copy of such inquiry, offer or proposal.

(4) For purposes of this Agreement, (i) "Business Combination" means (other than the transactions contemplated or permitted by this Agreement) (A) a merger, consolidation or other business combination, share exchange, sale of shares of capital stock, tender offer or exchange offer or similar transaction involving PNT or any of its Subsidiaries, (B) acquisition in any manner, directly or indirectly, of a material interest in any capital stock of, or a material equity interest in a substantial portion of the assets of, PNT or any of its Subsidiaries, including any single or multi-step transaction or series of related transactions that is structured to permit a third party to acquire beneficial ownership of a majority or greater equity interest in PNT or any of its Subsidiaries, or (C) the acquisition in any manner, directly or indirectly, of any material portion of the business or assets (other than immaterial or insubstantial assets or inventory in the ordinary course of business or assets held for sale) of PNT or any of its Subsidiaries and (ii)

"Superior Proposal" means a proposed Business Combination involving at least 50% of the shares of capital stock or a material portion of the assets of PNT that PNT's Board of Directors determines, after consulting with PNT's financial advisors and outside counsel, is financially superior to the transactions contemplated hereby and it appears that the party making the proposal is reasonably likely to have the funds necessary to consummate the Business Combination.

(i) Solicitation of Proxies; PNT Proxy Statement. Subject to Section 6.1(h), PNT shall use its reasonable best efforts to solicit from its shareholders proxies in favor of the Merger and shall take all other action necessary or, in the reasonable opinion of SUG, advisable to secure the PNT Shareholders' Approval. PNT shall cause PG Energy and Honesdale to approve the Honesdale Merger and the PG Energy Merger.

(j) PNT Shareholder Approval.

(1) Subject to the provisions of Section 6.1(h) and Section 6.1(j)(2), PNT shall, as soon as reasonably practicable after the date hereof (i) take all steps necessary to duly call, give notice of, convene and hold a meeting of its shareholders (including all adjournments thereof, the "PNT Meeting") for the purpose of securing the PNT Shareholders' Approval, (ii) distribute to its shareholders the PNT Proxy Statement in accordance with applicable federal and state law and with its Organizational Documents, (iii) subject to the fiduciary duties of its Board of Directors, recommend to its shareholders the approval of this Agreement and the transactions contemplated hereby and (iv) cooperate and consult with SUG with respect to each of the foregoing matters.

(2) The PNT Meeting for the purpose of securing the PNT Shareholders' Approval, including any adjournments thereof, will be held on such date or dates as PNT and SUG mutually determine.

(k) Rule 145 Letters. PNT shall promptly identify to SUG all officers and directors of any Acquired Company and any other persons who are "affiliates" within the meaning of such term as used in Rule 145 under the Securities Act ("Rule 145 Affiliates"), and PNT shall use its reasonable efforts to provide to SUG undertakings from such persons ("Rule 145 Letters") to the effect that no disposition of shares of SUG Common Stock received in the Merger will be made by such persons except within the limits and in accordance with the applicable provisions of said Rule 145, as amended from time to time, or except in a transaction which, in the opinion of legal counsel satisfactory to SUG, is exempt from registration under the Securities Act.

(l) Financing Activities. PNT shall, and shall cause its Subsidiaries to, cooperate, to the fullest extent commercially reasonable and practicable, with SUG's requests with respect to refinancing by the Acquired Companies of the current maturities of any of their indebtedness, and any repurchase, redemption or prepayment by any of the Acquired Companies of any of its indebtedness or preferred stock that may be required prior to or because of the Mergers or that SUG may request that the Acquired Companies effect prior to the Mergers, so as to permit SUG to have the maximum opportunity to refinance, on or promptly after the Closing

Date without any penalty except as may be due pursuant to the terms of the Acquired Companies' indebtedness and preferred stock as in effect on the date of this Agreement, any of the Acquired Companies' indebtedness or preferred stock outstanding on the Closing Date, including, but not limited to, the redemption or repurchase by PG Energy (or purchase by PNT) by the Effective Time of all outstanding shares of PG Preferred Stock; provided, however, that no Acquired Company shall be required to consummate prior to the Effective Time any such refinancing, repurchase, redemption or repayment requested by SUG.

(m) PNT Disclosure Schedule. On the date hereof, PNT has delivered to SUG the PNT Disclosure Schedule, accompanied by a certificate signed by an executive officer of PNT stating the PNT Disclosure Schedule is being delivered pursuant to this Section 6.1(m). The PNT Disclosure Schedule constitutes an integral part of this Agreement and modifies the representations, warranties, covenants or agreements of PNT contained herein to the extent that such representations, warranties, covenants or agreements expressly refer to the PNT Disclosure Schedule.

Section 6.2 Covenants of SUG. SUG agrees to observe and perform the following covenants and agreements:

(a) Governmental Approvals; Third Party Consents. SUG will use its reasonable best efforts at SUG's sole expense to obtain all necessary consents, approvals and waivers from any Person required under any license, lease, permit, Contract or agreement applicable to SUG, including, without limitation, the approvals of the Missouri Public Service Commission, the Florida Public Service Commission and the Pennsylvania Public Utility Commission as described in Section 4.5 and as required by the HSR Act.

(b) Employees; Benefits. With respect to the employees (excluding unionized employees) listed in Section 5.17(a) of the PNT Disclosure Schedule (or their successors employed pursuant to Section 6.1(a)(7) above) (the "Employees"), except as otherwise specified herein, SUG agrees as follows:

(1) During the 12 months immediately following the Closing Date, to make available to the Employees who continue their service with the Surviving Corporation or any Subsidiary of the Surviving Corporation Benefit Plans that are no less favorable, in the aggregate, than the Benefit Plans listed in Section 5.18 of the PNT Disclosure Schedule offered to the Employees immediately prior to the Effective Time. Notwithstanding the foregoing, SUG's obligations under PNT's Directors' Retirement Plan, Directors' 1995 Stock Compensation Plan and Directors' Deferred Compensation Plan shall be limited to obligations accrued through and including the Effective Time, including, but not limited to, the change in control provisions contained in such plans.

(2) For purposes of eligibility, vesting and benefit accrual under all benefit plans provided to the Employees after the Closing Date, SUG will recognize the tenure of employment, as recognized by the Acquired Companies as of the Closing Date.

(3) All vacation time earned by the Employees prior to the Closing Date must be taken by the end of the calendar year of the Closing Date, except where the Employee is requested by PNT or SUG to forego their vacation for business-related reasons. For purposes of awarding vacation time at the beginning of each calendar year following the Closing Date, SUG will recognize the tenure of employment, as recognized by the Acquired Company as of the Closing Date.

(4) SUG will permit each of the Employees to carry forward all days of sick leave accrued prior to the Closing Date.

(c) Rule 16b-3. SUG will take all reasonable steps so that the acquisition of the Merger Consideration by officers and directors of PNT (including Merger Consideration with respect to PNT Common Stock held under PNT Benefit Plans), and cash payments or substitute SUG options issued in exchange for PNT Options in accordance with Section 3.4, will be exempt from Section 16(b) of the Exchange Act by reason of Rule 16b-3 promulgated thereunder.

(d) Tax Matters. SUG will not take, or fail to take, any action before or after the Closing Date that will adversely affect the qualification of the Merger(s) as a reorganization under Section 368(a)(1)(A) of the IRC.

(e) Blue Sky Permits. SUG shall use its best efforts to obtain, prior to the effective date of the Registration Statement, all necessary state securities laws or "blue sky" permits and approvals required to carry out the transactions contemplated by the Agreement, and will pay all expenses incident thereto.

(f) Listing Application. Prior to the Closing, SUG shall cause the shares of SUG Common Stock constituting the Stock Consideration and any other such shares required to be reserved for issuance in connection with the Merger to be listed on the NYSE, subject to official notice of issuance thereof.

(g) Directors. After the Effective Time on the Closing Date, three individuals to be selected prior to the Closing Date by SUG from the Board of Directors of PNT immediately prior to the Effective Time shall be elected to the Board of Directors of SUG as the Surviving Corporation, and thereafter nominated and recommended for reelection if necessary such that each of them shall have a term of at least three years from the Closing Date, and each such individual shall hold office in accordance with the Certificate of Incorporation and By-laws of SUG as the Surviving Corporation; provided that, any such individual who is also an officer or employee of the Surviving Corporation shall be required to resign as a director of the Surviving Corporation if he resigns or is terminated as an officer or employee of the Surviving Corporation.

(h) Technology: Pennsylvania Operations. SUG will give full consideration to using or retaining PNT's technology and management systems for the PNT operations after the Effective Time, if SUG determines that they are superior to such technology and management systems being used by SUG in its other operations and it is in the best interests of SUG and PNT's

operations. *SUG* intends to operate the Acquired Companies' utility operations in Pennsylvania as a separate division of the Surviving Corporation headquartered in Pennsylvania.

(i) Charitable Contributions. *SUG* will maintain PNT's charitable contributions of at least the amount given and/or committed in 1998 for at least the next three calendar years.

(j) Collective Bargaining Agreements. At the Effective Time, *SUG* agrees to assume all collective bargaining agreements covering employees of any Acquired Company, and shall discharge when due any and all liabilities of any Acquired Company under such collective bargaining agreements relating to periods after the Effective Time.

(k) Restrictions on Unusual Distributions: Anti-Dilution. Except for an annual 5% stock dividend, *SUG* will not, prior to the Effective Time, declare any stock dividend, stock split, reclassification, recapitalization, combination or distribution of assets, securities or other property to holders of, or affecting, *SUG* Common Stock.

(l) Solicitation of Proxies: *SUG* Proxy Statement. *SUG* shall use its reasonable best efforts to solicit from *SUG*'s shareholders proxies in favor of the Merger and shall take all other action necessary or, in the reasonable opinion of PNT, advisable to secure the *SUG* Shareholders' Approval. All Lindemann family members who own shares of *SUG* Common Stock as of the date of this Agreement have provided PNT with a commitment and irrevocable proxy to vote all of their shares of *SUG* Common Stock in favor of the Merger, the form of which is attached hereto as Schedule 6.2(l).

(m) *SUG* Shareholder Approval.

(1) Subject to the provisions of Section 6.2(m)(2), *SUG* shall, as soon as reasonably practicable after the date hereof (i) take all steps necessary to duly call, give notice of, convene and hold a meeting of its shareholders (including all adjournments thereof, the "*SUG* Meeting") for the purpose of securing the *SUG* Shareholders' Approval, (ii) distribute to its shareholders the *SUG* Proxy Statement in accordance with applicable federal and state law and with its Organizational Documents, (iii) subject to the fiduciary duties of its Board of Directors, recommend to its shareholders the approval of this Agreement and the transactions contemplated hereby and (iv) cooperate and consult with PNT with respect to each of the foregoing matters.

(2) The *SUG* Meeting for the purpose of securing the *SUG* Shareholders' Approval, including any adjournments thereof, will be held on such date or dates as PNT and *SUG* mutually determine.

(n) *SUG* Disclosure Schedule. On the date hereof, *SUG* has delivered to PNT the *SUG* Disclosure Schedule, accompanied by a certificate signed by an executive officer of *SUG* stating that the *SUG* Disclosure Schedule is being delivered pursuant to this Section 6.2(n). The *SUG* Disclosure Schedule constitutes an integral part of this Agreement and modifies the representations, warranties, covenants or agreements of *SUG* contained herein to the extent that

such representations, warranties, covenants or agreements expressly refer to the **SUG Disclosure Schedule**.

(o) **Conduct of the Business Prior to the Closing Date.** Except as contemplated in this Agreement, as required by law or regulation or as otherwise expressly consented to in writing by PNT which consent will not be unreasonably withheld, prior to the Closing, **SUG will:**

(1) Not make or permit any material change in the general nature of its business;

(2) Maintain its present operations in the Ordinary Course of Business in accordance with prudent business judgment and consistent with past practice and policy, and maintain its assets in good repair, order and condition, reasonable wear and tear excepted, subject to retirements in the Ordinary Course of Business;

(3) Preserve **SUG** as an ongoing business and use reasonable efforts to maintain the goodwill associated with **SUG**; and

(4) Preserve all of **SUG's** franchises, tariffs, certificates of public convenience and necessity, licenses, authorizations and other governmental rights and permits.

(p) **Access to **SUG's** Offices, Properties and Records; Updating Information.**

(1) From and after the date hereof and until the Closing Date, **SUG** and its Subsidiaries shall permit PNT and its Representatives to have, on reasonable notice and at reasonable times, reasonable access to such of the offices, properties and employees of **SUG** and its Subsidiaries, and shall disclose, and make available to PNT and its Representatives all books, papers and records to the extent that they relate to the ownership, operation, obligations and liabilities of or pertaining to **SUG**, its Subsidiaries and their respective businesses and assets. Without limiting the application of the Confidentiality Agreement, all documents or information furnished by **SUG** and its Subsidiaries hereunder shall be subject to the Confidentiality Agreement.

(2) **SUG** will notify PNT as promptly as practicable of any significant change in the Ordinary Course of Business or operation of **SUG** or any of its Subsidiaries and of any material complaints, investigations or hearings (or communications indicating that the same may be contemplated) by any Governmental Body, or the institution or overt threat or settlement of any material Proceeding involving or affecting **SUG** or any of its Subsidiaries or the transactions contemplated by this Agreement, and shall use reasonable efforts to keep PNT fully informed of such events and permit PNT's Representatives access to all materials prepared in connection therewith consistent with any applicable Legal Requirement or Contract.

(3) As promptly as practicable after PNT's request, SUG will furnish such financial and operating data and other information pertaining to SUG, its Subsidiaries and their respective businesses and assets as PNT may reasonably request; provided, however, that nothing herein will obligate SUG or any of its Subsidiaries to take actions that would unreasonably disrupt its Ordinary Course of Business or violate the terms of any Legal Requirement or Contract to which SUG or any of its Subsidiaries is a party or to which any of its assets is subject in providing such information, or to incur any costs with respect to PNT's external auditors (or SUG's external auditors in the event a report by such auditors is requested by PNT) providing accounting services with respect to issuing an auditor's report required by or for PNT.

Section 6.3 Additional Agreements.

(a) The Registration Statement, the PNT Proxy Statement and the SUG Proxy Statement. As soon as practicable after the date hereof, PNT and SUG shall take such reasonable steps as are necessary for the prompt preparation and filing with the SEC of (i) the PNT Proxy Statement by PNT, (ii) the SUG Proxy Statement by SUG and (iii) the Registration Statement, which will include information contained in the PNT Proxy Statement, by SUG. The foregoing shall include without limitation: (i) obtaining and furnishing the information required to be included therein, (ii) after consultation between PNT and SUG, responding promptly to any comments made by the SEC with respect to the PNT Proxy Statement, the SUG Proxy Statement and the Registration Statement and any amendments and preliminary version thereof and (iii) causing the Registration Statement to become effective, the PNT Proxy Statement to be mailed to PNT's shareholders at the earliest practicable date and the SUG Proxy Statement to be mailed to SUG's shareholders at the earliest practicable date. PNT agrees, as to information with respect to PNT, its officers, directors, shareholders and Subsidiaries contained in the Registration Statement, the PNT Proxy Statement and the SUG Proxy Statement, and SUG agrees, as to information with respect to SUG, its officers, directors, shareholders and Subsidiaries contained in the Registration Statement, the PNT Proxy Statement and the SUG Proxy Statement, that such information, in the case of the PNT Proxy Statement at the time of the mailing of the PNT Proxy Statement and (as then amended or supplemented) at the time of the PNT Meeting, in the case of the SUG Proxy Statement, at the time of the mailing of the SUG Proxy Statement and (as then amended or supplemented) at the time of the SUG Meeting or in the case of the Registration Statement at the time of the mailing of the PNT Proxy Statement (as then amended or supplemented), at the time of the PNT Meeting and at the effective time of the Registration Statement, will not contain any untrue statement of material fact required to be stated therein or necessary in order to make the statements therein, in light of the circumstances under which they are made, not misleading. No representation, warranty, covenant or agreement is made by or on behalf of PNT with respect to information supplied by any other party for inclusion in the PNT Proxy Statement, the SUG Proxy Statement or the Registration Statement. No representation, warranty, covenant or agreement is made by or on behalf of SUG with respect to information supplied by any other party for inclusion in the PNT Proxy Statement, the SUG Proxy Statement or the Registration Statement. No filing of, or amendment or supplement to, the PNT Proxy Statement, the SUG Proxy Statement or the Registration Statement shall be made by any party hereto without providing the other party with the opportunity to review and comment thereon

(except for any ongoing SEC reporting required of SUG, PNT or PG Energy that will be incorporated by reference). If at any time prior to the Effective Time any information relating to any party hereto or any of their respective officers, directors, shareholders or Subsidiaries, should be discovered by any party hereto which should be set forth in an amendment or supplement to the PNT Proxy Statement, the SUG Proxy Statement or the Registration Statement so that the PNT Proxy Statement, the SUG Proxy Statement or the Registration Statement would not include any untrue statement of a material fact or omit to state any material fact necessary to make the statements therein, in light of the circumstances under which they were made, not misleading, the party which discovers such information shall promptly notify the other party hereto and an appropriate amendment or supplement describing such information shall be promptly prepared, filed with the SEC and, to the extent required by law, disseminated to the shareholders of PNT and/or the shareholders of SUG, as may be necessary.

(b) Further Assurances. Each of SUG, PNT and any Acquired Company agrees to take all such reasonable and lawful action as may be necessary or appropriate in order to effectuate the Merger in accordance with this Agreement as promptly as possible. If, at any time after the Effective Time, any such further action is necessary or desirable to carry out the purpose of this Agreement and to vest PNT or SUG with full right, title and possession to all assets, property, rights, privileges, powers and franchises of the Acquired Companies, PNT's shareholders and the officers and directors of the Acquired Companies immediately prior to the Effective Time are fully authorized in the name of their respective corporations or otherwise to take, and will take, all such lawful and necessary action.

ARTICLE VII CONDITIONS

Section 7.1 Conditions to SUG's Obligation to Effect the Merger. The obligation of SUG to effect the transactions contemplated by this Agreement shall be subject to fulfillment at or prior to the Closing of the following conditions:

(a) Representations and Warranties True as of the Closing Date. PNT's representations and warranties in this Agreement shall have been accurate in all material respects as of the date of this Agreement and shall be accurate in all material respects as of the Closing Date as if made on the Closing Date, subject to changes expressly contemplated and permitted by this Agreement; provided that, any such representation or warranty that is qualified by any standard of materiality (including, but not limited to, PNT Material Adverse Effect) shall have then been, and shall then be, accurate in all respects.

(b) Compliance with Agreements. The covenants, agreements and conditions required by this Agreement to be performed and complied with by any of the Acquired Companies shall have been performed and complied with in all material respects prior to or at the Closing Date.

(c) Certificate. PNT shall execute and deliver to SUG a certificate of an authorized officer of PNT, dated the Closing Date, stating that the conditions specified in Sections 7.1(a) and 7.1(b) of this Agreement applicable to the Acquired Companies have been satisfied.

(d) Governmental Approvals. All approvals, consents, opinions or rulings of all Governmental Bodies required in order to consummate the transactions contemplated hereby shall have been obtained by Final Order in such form as is, and with no conditions that are, individually or in the aggregate, reasonably likely to have a PNT Material Adverse Effect or a material adverse effect on the business, operations, properties, financial condition or results of operations of the Surviving Corporation. The applicable waiting period under the HSR Act with respect to the transactions contemplated hereby shall have expired or have been terminated.

(e) Third Party Consents. Each of the consents required under Section 5.4 of this Agreement shall have been obtained to the reasonable satisfaction of SUG, other than any such consents which, if not obtained, are not, individually or in the aggregate, reasonably likely to result in a PNT Material Adverse Effect after the Closing. In addition, all consents and approvals required, under the terms of any note, bond or indenture listed on the schedule to be delivered pursuant to Section 5.4, to which any of the Acquired Companies is a party, shall have been obtained.

(f) Injunctions. On the Closing Date, there shall be no Orders which operate to restrain, enjoin or otherwise prevent the consummation of this Agreement or the Mergers.

(g) Resignations. Each director of each Acquired Company shall, if requested by SUG, resign any position as a director of an Acquired Company effective as of the Closing Date in accordance with such Subsidiary's Organizational Documents and applicable provisions of the PBCL; provided that, such resignations shall not cause the termination of any such Person's employment as an employee of an Acquired Company or reduce any such employee's then current level of compensation.

(h) Opinion of Tax Counsel. On the Closing Date, SUG shall have received from Roberts and Holland, L.L.P., special tax counsel to SUG, an opinion to the effect that the Merger will constitute a "reorganization" within the meaning of IRC Section 368(a)(1)(A), that the Honesdale Merger and the PG Energy Merger will each constitute "reorganizations" within the meaning of IRC Section 368(a)(1)(A) or "liquidations" within the meaning of IRC Section 332, and that no gain or loss will be recognized by SUG or any of the Acquired Companies with respect to the Mergers.

(i) Shareholder Approvals. The SUG Shareholders' Approval and the PNT Shareholders' Approval shall have been obtained, and all of the outstanding shares of the PG Preferred Stock shall have been redeemed in accordance with the Organizational Documents of PG Energy, purchased by PNT or repurchased by PG Energy.

(j) Dissenter's Rights. Demand for payment of dissenters' rights by shareholders of PNT with respect to the Merger shall not equal or exceed seven percent of the outstanding shares of PNT Common Stock entitled to vote thereon.

(k) Rule 145 Letters. Each Rule 145 Affiliate shall have executed and delivered to SUG a Rule 145 Letter, in form and substance reasonably satisfactory to SUG and its counsel.

(l) Registration Statement. The Registration Statement shall have become effective, no stop order suspending the effectiveness of the Registration Statement shall have been issued and no proceedings for that purpose shall have been initiated or threatened by the SEC.

(m) Listing of SUG Common Stock. The shares of SUG Common Stock constituting the Stock Consideration and any other shares of SUG Common Stock required to be issued or reserved hereunder to consummate the transactions contemplated by this Agreement shall have been authorized for listing, upon official notice of issuance, on the NYSE.

Section 7.2 Conditions to PNT's Obligations to Effect the Mergers. The obligation of PNT to effect the transactions contemplated by this Agreement shall be subject to fulfillment at or prior to the Closing of the following conditions:

(a) Representations and Warranties True as of the Closing Date. SUG's representations and warranties in this Agreement shall have been accurate in all material respects as of the date of this Agreement and shall be accurate in all material respects as of the Closing Date as if made on the Closing Date, subject to changes expressly contemplated and permitted by this Agreement; provided that, any such representation or warranty that is qualified by any standard of materiality (including, but not limited to, SUG Material Adverse Effect) shall have then been, and shall then be, accurate in all respects.

(b) Compliance with Agreements. The covenants, agreements and conditions required by this Agreement to be performed and complied with by SUG shall have been performed and complied with in all material respects prior to or at the Closing Date.

(c) Certificate. SUG shall execute and deliver to PNT a certificate of an authorized officer of SUG, dated the Closing Date, stating that the conditions specified in Sections 7.2(a) and 7.2(b) of this Agreement applicable to SUG have been satisfied.

(d) Governmental Approvals. All approvals, consents, opinions or rulings of all Governmental Bodies required in order to consummate the transactions contemplated hereby shall have been obtained by Final Order in such form as is, and with no conditions that are, individually or in the aggregate, reasonably likely to have a material adverse effect on the business, operations, properties, financial condition or results of operations of the Surviving Corporation. The applicable waiting period under the HSR Act with respect to the transactions contemplated hereby shall have expired or have been terminated.

(e) Injunctions. On the Closing Date, there shall be no Orders which operate to restrain, enjoin or otherwise prevent the consummation of this Agreement or the Mergers.

(f) Opinion of Counsel. On the Closing Date, PNT shall have received from Hughes Hubbard & Reed LLP, counsel to PNT, an opinion to the effect that the Merger will be treated for federal income tax purposes as a "reorganization" within the meaning of IRC Section 368(a), and that no gain or loss will be recognized for federal income tax purposes by the shareholders of PNT upon their receipt of the Merger Consideration, except that any realized gain will be recognized to the extent of the amount of cash received.

(g) Shareholder Approvals. The SUG Shareholders' Approval and the PNT Shareholders' Approval shall have been obtained.

(h) Registration Statement: The Registration Statement shall have become effective, no stop order suspending the effectiveness of the Registration Statement shall have been issued and no proceedings for that purpose shall have been initiated or threatened by the SEC.

(i) Listing of SUG Common Stock. The shares of SUG Common Stock constituting the Stock Consideration and any other shares of SUG Common Stock required to be issued or reserved hereunder to consummate the transactions contemplated by this Agreement shall have been authorized for listing, upon official notice of issuance, on the NYSE.

ARTICLE VIII TERMINATION

Section 8.1 Termination Rights. This Agreement may be terminated in its entirety at any time prior to the Closing:

(a) By the mutual written consent of SUG and PNT;

(b) By PNT, on the one hand, or SUG, on the other hand, in writing if there shall be in effect a non-appealable order of a court of competent jurisdiction prohibiting the consummation of the Mergers in accordance with this Agreement;

(c) By PNT if there is a breach of any representation, warranty, covenant or agreement of SUG, which breach cannot be cured and would cause the conditions set forth in Section 7.2(a) to be incapable of being satisfied;

(d) By SUG if there is a breach of any representation, warranty, covenant or agreement of PNT, which breach cannot be cured and would cause the conditions set forth in Section 7.1(a) to be incapable of being satisfied;

(e) By PNT, by written notice to SUG in accordance with Section 6.1(h)(2); provided, however, that the termination described in this clause (e) shall not be effective unless and until PNT shall have paid SUG the fee described in Section 8.3(a) and PNT has substantially

contemporaneously entered into a definitive agreement with respect to a Business Combination Proposal;

(f) By PNT, in writing if the PNT Shareholders' Approval is not obtained at the PNT Meeting or the SUG Shareholders' Approval is not obtained at the SUG Meeting or by SUG in writing if the PNT Shareholders' Approval is not obtained at the PNT Meeting provided that there has not been a material misrepresentation or a material breach of covenant, warranty or agreement contained herein on the part of the party asserting its right to terminate pursuant to this Section 8.1(f);

(g) By PNT, if the Average Trading Price of the SUG Common Stock as of the Closing is lower than \$17.30000.

(h) By SUG, by written notice to PNT, if the Board of Directors of PNT or any committee thereof (i) withdraws or modifies, or proposes publicly to withdraw or modify, in a manner adverse to SUG, the approval or recommendation by the Board of Directors or such committee of the Merger or this Agreement, (ii) approves or recommends, or proposes publicly to approve or recommend, a Business Combination, (iii) causes PNT to enter into a definitive agreement related to any Business Combination, (iv) resolves to take any of the actions specified in clause (i), (ii) and (iii) above or (v) fails by the Effective Time to cause PG Energy to redeem or repurchase all of the outstanding shares of PG Preferred Stock;

(i) By SUG, by written notice to PNT, if a third party, including a group (as defined under the Exchange Act) acquires securities representing greater than 50% of the voting power of the outstanding voting securities of PNT; or

(j) By either party in writing at any time after 5:00 p.m., Eastern Time on June 7, 2000, (the "Initial Termination Date") if the Closing has not occurred prior thereto; provided, however, that the right to terminate this Agreement under this Section 8.1(j) will not be available to any party that is in material breach of its representations, warranties, covenants or agreements contained herein; and provided, further, that if on the Initial Termination Date (i) the conditions to closing set forth in Sections 7.1(d) and 7.2(d) shall not have been fulfilled or (ii) any approval or authorization of any Governmental Body required in connection with the consummation of the Mergers shall have not been obtained and such approval or authorizations shall not have become a Final Order, but all other conditions to Closing shall be fulfilled or shall be capable of being fulfilled, then the Initial Termination Date will be extended to December 7, 2000.

Section 8.2 Effect of Termination. If this Agreement is terminated pursuant to Section 8.1, this Agreement shall be of no further force and effect and there shall be no further liability hereunder on the part of any party or its affiliates, directors, officers, shareholders, agents or other representatives; provided, however, that no such termination shall relieve any party of liability for any claims, damages or losses suffered by the other party as a result of the negligent or willful failure of a party to perform any obligations required to be performed by it hereunder on or prior to the date of termination. Notwithstanding anything to the contrary contained herein, the provisions of Section 8.2, Sections 10.1 through 10.6 and Sections 10.8 through 10.11 of this

Agreement shall survive any termination of this Agreement. Notwithstanding anything to the contrary contained herein, but subject to Section 7.1(i), Section 8.1(h) and Section 8.2, the failure by PG Energy to obtain the approval of the transactions contemplated by this Agreement by the holders of either series of PG Preferred Stock in the event such approval may be determined to be required shall not constitute a breach by PNT of any of its representations, warranties or covenants contained herein.

Section 8.3 Termination Fee; Expenses.

(a) Termination Fee. If this Agreement is terminated pursuant to Section 8.1(e), 8.1(h) or 8.1(i), then PNT shall pay to SUG promptly (but not later than five business days after notice is received from PNT) an amount equal to \$10 million in cash.

(b) Expenses. The parties agree that the agreements contained in this Section 8.3 are an integral part of the transactions contemplated by this Agreement and constitute liquidated damages and not a penalty. Notwithstanding anything to the contrary contained in this Section 8.3, if PNT fails to pay promptly to SUG the fee due under Section 8.3(a), in addition to any amounts paid or payable pursuant to Section 8.3(a), PNT shall pay the costs and expenses (including legal fees and expenses) in connection with any action, including the filing of any lawsuit or other legal action, taken to collect payment, together with interest on the amount of any unpaid fee calculated using an annual percentage rate of interest equal to the prime rate published in the *Wall Street Journal* on the date (or preceding business day if such date is not a business day) such fee was required to be paid, compounded on a daily basis using a 360-day year.

ARTICLE IX INDEMNIFICATION; REMEDIES

Section 9.1 Directors' and Officer's Indemnification.

(a) Indemnification and Insurance. For a period of six years after the Effective Time, the Surviving Corporation will indemnify and hold harmless the present and former officers and directors of PNT and its Subsidiaries (the "Indemnified Parties") in respect of acts or omissions occurring prior to the Effective Time to the extent provided under PNT's certificate of incorporation and bylaws in effect on the date hereof; provided, however, that if any claim or claims are asserted or made within such six-year period, all rights to indemnification in respect of such claims shall continue until the final disposition of any and all such claims. For six years after the Effective Time, the Surviving Corporation will use its reasonable best efforts to provide officers' and directors' liability insurance in respect of acts or omissions occurring prior to the Effective Time covering each such person currently covered by PNT's officers' and directors' liability insurance policy on terms with respect to coverage and amount no less favorable than those of such policy in effect on the date hereof; provided that in satisfying its obligation under this Section, if the annual premiums of such insurance coverage exceed 200% of the previous year's premiums, the Surviving Corporation will be obligated to obtain a policy with the best coverage available, in the reasonable judgment of the Board of Directors of the Surviving Corporation for a cost not exceeding such amount.

(b) Successors. In the event the Surviving Corporation or any of its successors or assigns (i) consolidates with or merges into any other Person and is not the continuing or surviving corporation or entity of such consolidation or merger or (ii) transfers all or substantially all of its properties and assets to any Person, then and in either such case, proper provisions must be made so that the successors and assigns of the Surviving Corporation will assume the obligations set forth in this Section 9.1.

(c) Survival of Indemnification. To the fullest extent permitted by law, from and after the Effective Time, all rights to indemnification as of the date hereof in favor of the employees, agents, directors and officers of any Acquired Company with respect to their activities as such prior to the Effective Time, as provided in their respective Organizational Documents in effect on the date hereof, or otherwise in effect on the date hereof, will survive the Mergers and will continue in full force and effect except for amendments to make changes permitted by law that would enhance the rights of past or present officers and directors to indemnification or advancement of expenses in respect of acts or omissions occurring prior to the Effective Time. for a period of not less than six years from the Effective Time (or, in the case of matters occurring prior to the Effective Time which have not been resolved prior to the sixth anniversary of the Effective Time, until such matters are finally resolved).

Section 9.2 Representations and Warranties. Each and every representation and warranty of either party shall expire at, and be terminated and extinguished with, the Effective Time.

ARTICLE X GENERAL PROVISIONS

Section 10.1 Expenses. Each of the parties will pay all costs and expenses of its performance of and compliance with this Agreement, except (i) as provided in Section 8.3 and as expressly provided otherwise herein, (ii) PNT shall pay all fees and expenses of counsel for PNT, (iii) SUG will pay all real estate transfer taxes and real estate recording fees, if any, including expenses of counsel associated with real estate title, transfer and recording issues in connection with the Mergers, and all filing and application fees paid to Governmental Bodies in connection with the Mergers and (iv) SUG and PNT will each pay half of the combined costs of printing and mailing to the PNT stockholders the prospectus that is a part of the Registration Statement and the Proxy Statement.

Section 10.2 Notices. All notices, requests and other communications hereunder shall be in writing and shall be deemed to have been given upon receipt if either (a) personally delivered, (b) sent by prepaid first class mail, and registered or certified and a return receipt requested or (c) by facsimile telecopier with completed transmission acknowledged:

if to SUG, to:

Southern Union Company
504 Lavaca Street, Suite 800
Austin, Texas 78701
Attention: Peter H. Kelley
President and Chief Operating Officer
Telecopier: (512) 477-3879

with a copy to:

Fleischman and Walsh, L.L.P.
Suite 600
1400 Sixteenth Street, N.W.
Washington, D.C. 20036
Attention: Stephen A. Bouchard, Esq.
Telecopier: (202) 265-5706

if to PNT, to:

Pennsylvania Enterprises, Inc.
One PEI Center
Wilkes-Barre, Pennsylvania 18711-0601
Attention: Thomas F. Karam
President and Chief Executive Officer
Telecopier: (570) 829-8900

with a copy to:

Hughes Hubbard & Reed LLP
One Battery Park Plaza
New York, New York 10004-1482
Attention: Garrett J. Albert, Esq.
Telecopier: (212) 422-4726

or at such other address or number as shall be given in writing by a party to the other parties.

Section 10.3 Assignment. This Agreement may not be assigned by any party hereto without the prior written consent of the other parties hereto.

Section 10.4 Successor Bound. Subject to the provisions of Section 10.3, this Agreement shall be binding upon and inure to the benefit of the parties hereto and their respective successors and assigns.

Section 10.5 Governing Law; Forum; Consent to Jurisdiction. This Agreement shall be construed in accordance with and governed by the laws of the State of New York except to the extent that the terms and consummation of the Mergers are subject to the DGCL or the PBCL. Each party to this Agreement hereby irrevocably and unconditionally (i) consents to submit to the exclusive jurisdiction of the federal courts of the Southern District of New York in the county of New York and the borough of Manhattan for any proceeding arising in connection with this Agreement (and each such party agrees not to commence any such proceeding, except in such courts), (ii) to the extent such party is not a resident of the State of New York, agrees to appoint an agent in the State of New York as such party's agent for acceptance of legal process in any such proceeding against such party with the same legal force and validity as if served upon such party personally within the State of New York, and to notify promptly each other party hereto of the name and address of such agent, (iii) waives any objection to the laying of venue of any such proceeding in the federal courts of the Southern District of New York in the county of New York and the burrough of Manhattan, and (iv) waives, and agrees not to plead or to make, any claim that any such proceeding brought in any federal court of the Southern District of New York has been brought in an improper or otherwise inconvenient forum.

Section 10.6 Waiver of Trial By Jury. EACH PARTY TO THIS AGREEMENT HEREBY WAIVES TRIAL BY JURY IN ANY ACTION OR PROCEEDING TO WHICH ANY SUCH PARTY MAY BE PARTIES ARISING OUT OF OR IN ANY WAY PERTAINING TO (i) THIS AGREEMENT, (ii) THE MERGERS, (iii) THE CONFIDENTIALITY AGREEMENT OR (iv) ANY RELATED DOCUMENTS. IT IS AGREED AND UNDERSTOOD THAT THIS WAIVER CONSTITUTES A WAIVER OF TRIAL BY JURY OF ALL CLAIMS AGAINST ALL PARTIES WHO ARE NOT PARTIES TO THIS AGREEMENT. THIS WAIVER IS KNOWINGLY, WILLINGLY AND VOLUNTARILY MADE BY EACH PARTY HERETO, AND EACH SUCH PARTY HEREBY REPRESENTS AND WARRANTS THAT NO REPRESENTATIONS OF FACT OR OPINION HAVE BEEN MADE BY ANY PERSON TO INDUCE THIS WAIVER OR TRIAL BY JURY OR TO IN ANY WAY MODIFY OR NULLIFY ITS EFFECT. EACH PARTY TO THIS AGREEMENT FURTHER REPRESENTS AND WARRANTS THAT EACH SUCH PARTY HAS BEEN REPRESENTED IN THE SIGNING OF THIS AGREEMENT AND IN THE MAKING OF THIS WAIVER BY INDEPENDENT LEGAL COUNSEL, SELECTED OF EACH SUCH PARTY'S OWN FREE WILL, AND THAT EACH SUCH PARTY HAS HAD THE OPPORTUNITY TO DISCUSS THIS WAIVER WITH COUNSEL.

Section 10.7 Cooperation; Further Documents.

(a) Each of the parties hereto agrees to use its reasonable best efforts to take or cause to be taken all action, and to do or cause to be done all things necessary, proper or advisable under applicable laws, regulations or otherwise, to consummate and to make effective the transactions contemplated by this Agreement, including, without limitation, the timely performance of all actions and things contemplated by this Agreement to be taken or done by each of the parties hereto.

(b) Each party shall cooperate with the other party in such other party's discharge of the obligations hereunder, which shall include making reasonably available to the other party such of its personnel as have relevant information, with respect thereto.

Section 10.8 Construction of Agreement. The terms and provisions of this Agreement represent the results of negotiations between PNT and SUG, each of which has been represented by counsel of its own choosing, and neither of which has acted under duress or compulsion, whether legal, economic or otherwise. Accordingly, the terms and provisions of this Agreement shall be interpreted and construed in accordance with their usual and customary meanings, and PNT and SUG hereby waive the application in connection with the interpretation and construction of this Agreement of any rule of law to the effect that ambiguous or conflicting terms or provisions contained in this Agreement shall be interpreted or construed against the party whose attorney prepared the executed draft or any earlier draft of this Agreement.

Section 10.9 Publicity; Organizational and Operational Announcements. No party hereto shall issue, make or cause the publication of any press release or other announcement with respect to this Agreement or the transactions contemplated hereby, or otherwise make any disclosures relating thereto, without the consent of the other party, such consent not to be unreasonably withheld or delayed; provided, however, that such consent shall not be required where such release or announcement is required by applicable law or the rules or regulations of a securities exchange, in which event the party so required to issue such release or announcement shall endeavor, wherever possible, to furnish an advance copy of the proposed release to the other party.

Section 10.10 Waiver. Except as otherwise expressly provided in this Agreement, neither the failure nor any delay on the part of any party to exercise any right, power or privilege hereunder shall operate as a waiver thereof, nor shall any single or partial exercise or waiver of any such right, power or privilege preclude any other or further exercise thereof, or the exercise of any other right, power or privilege available to each party at law or in equity.

Section 10.11 Parties in Interest. This Agreement (including the documents and instruments referred to herein) is not intended to confer upon any Person, other than the parties hereto and their successors and permitted assigns, any rights or remedies hereunder, except that the parties hereto agree and acknowledge that the agreements and covenants contained in Section 6.2(g) are intended for the direct and irrevocable benefit of each director of PNT selected by SUG prior to the Closing Date pursuant thereto, and that the agreements and covenants contained in Section 9.1 are intended for the direct and irrevocable benefit of the Indemnified Parties described therein and their respective heirs or legal representatives (each such director or Indemnified Party, a "Third Party Beneficiary"), and that each such Third Party Beneficiary, although not a party to this Agreement, shall be and is a direct and irrevocable third party beneficiary of such agreements and covenants and shall have the right to enforce such agreements and covenants against the Surviving Corporation in all respects fully and to the same extent as if such Third Party Beneficiary were a party hereto.

Section 10.12 Specific Performance. The parties hereto agree that irreparable damage would occur to a party in the event that any of the provisions of this Agreement were not performed in accordance with their specific terms or were otherwise breached. It is accordingly agreed that any party shall be entitled to an injunction or injunctions to prevent breaches of this agreement by any other party and to enforce specifically, to the fullest extent available, the terms and provisions hereof, including each party's obligation to close, in any court of the United States or any state having jurisdiction, this being in addition to any other right or remedy to which any party is entitled at law or in equity.

Section 10.13 Section and Paragraph Headings. The section and paragraph headings in this Agreement are for reference purposes only and shall not affect in any way the meaning or interpretation of this Agreement.

Section 10.14 Amendment. This Agreement may be amended only by an instrument in writing executed by the parties hereto.

Section 10.15 Entire Agreement. This Agreement, the exhibits, annexes and schedules hereto and the documents specifically referred to herein and the Confidentiality Agreement constitute the entire agreement, understanding, representations and warranties of the parties hereto.

Section 10.16 Counterparts. This Agreement may be executed in one or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

[SIGNATURES APPEAR ON FOLLOWING PAGE]

IN WITNESS WHEREOF, the parties have executed and delivered this Agreement as of the date first written above.

SOUTHERN UNION COMPANY

By: Peter H. Kelley

Name: Peter H. Kelley

Title: President and Chief Operating Officer

PENNSYLVANIA ENTERPRISES, INC.

By: T. F. Karam

Name: Thomas F. Karam

Title: President and Chief Executive Officer

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