



Southern Union Company  
1999 Annual Report  
Planning Our Next Moves

SOUTHERN UNION COMPANY  
504 LAVACA STREET, SUITE 800  
AUSTIN, TEXAS 78701  
TELEPHONE: 512.477.5852  
WWW.SOUTHERNUNIONCO.COM  
4160-AR-99

**ABOUT SOUTHERN UNION COMPANY**

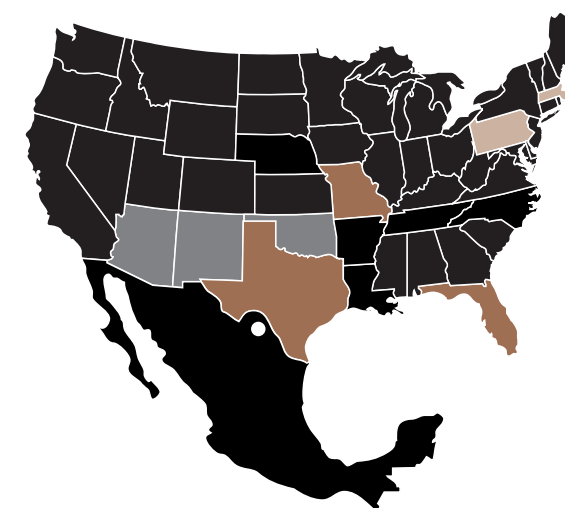
As the fifteenth largest natural gas distributor in the nation, Southern Union Company serves more than one million customers through: three gas distribution divisions – Southern Union Gas, Missouri Gas Energy and Atlantic Utilities; its propane distribution subsidiaries, SUPro Energy Company and Atlantic Gas Corporation; and its equity ownership in a natural gas distribution company serving Piedras Negras, Mexico. Southern Union Gas serves 513,000 customers in Texas. Missouri Gas Energy serves 484,000 customers in western Missouri.

Additionally, other company subsidiaries include Mercado Gas Services Inc.; Lavaca Realty Company; Southern Transmission Company; Southern Union Energy International Inc.; Norteño Pipeline Company; Southern Union International Investments, Inc.; Southern Union Total Energy Systems, Inc.; and Energía Estrella del Sur, S.A. de C.V.

A merger is also pending with Pennsylvania Enterprises, Inc., which serves 152,000 customers in northeastern and central Pennsylvania.

**STATES SERVED**

■ EXISTING OPERATIONS      ■ PENDING MERGER  
 ■ UNREGULATED SALES ONLY      □ PIEDRAS NEGRAS



**SELECTED FINANCIAL HIGHLIGHTS**

YEAR ENDED JUNE 30	1999	1998	INCREASE (DECREASE)
Net earnings	\$ 10,445,000	\$ 12,229,000	(15%)
Earnings per common share – diluted	\$ .32	\$ .39	(18%)
Return on average common equity	3.5%	4.3%	(19%)
Year-end stock price	\$ 20.71	\$ 19.50	6%
Year-end book value per share	\$ 9.83	\$ 9.55	3%
Operating revenues	\$ 605,231,000	\$ 669,304,000	(10%)
Net operating margin	\$ 230,896,000	\$ 228,838,000	1%
Common stockholders' equity	\$ 301,058,000	\$ 296,834,000	1%
Long-term debt	\$ 390,931,000	\$ 406,407,000	(4%)
Long-term debt as a percent of capitalization	49.0%	50.6%	(3%)
Total throughput (MMcf)	160,848	174,423	(8%)
Distribution customers—average served	998,476	979,186	2%
Employees	1,554	1,594	(3%)
Customers served per employee	634	614	3%
Revenue per average residential customer	\$ 409	\$ 463	(12%)
Weather as a percent of 30-year measure:			
Texas service territories	74%	99%	(25%)
Missouri service territories	85%	90%	(6%)

## Friends and Shareholders:

In 1929, Southern Union's first customers in Wink, Texas (about 250 miles east of El Paso, Texas), installed their own gaslines. Those humble beginnings established the groundwork for a little gas company that 70 years later has grown to become an international energy corporation serving more than one million customers. Under the name of Wink Gas Company, founder Clint Murchison ingeniously advertised that anyone wanting to buy gas could install his own pipeline and receive unlimited natural gas for a flat \$5 per month – no meter. Most people jumped at the deal and Wink Gas Company was on its way.

Today we still rely on the unconventional to succeed as a company. From the focus of our sales efforts in promoting innovative uses of natural gas to our issuance of a stock dividend rather than depleting our cash flow, we embrace what is considered “untraditional” in our industry to demonstrate a more progressive way to do business.

For those of you who remember our last year's letter, we spoke about experiencing the warmest winter ever. Well, this past year was warmer still. In fact, weather in Missouri was 15% warmer than the average of the last 30 years and weather in Texas was 26% warmer than this average.

Thus net earnings for fiscal 1999 were \$10,445,000 or \$.32 per common share. These results reflect after-tax costs of \$2,284,000 (\$.07 per share) associated with unsuccessful acquisition efforts. Excluding these costs, net earnings would have been \$12,729,000 or \$.39 per share which compares with \$12,229,000 or \$.39 per share in 1998. We estimate that the extremely warm winter reduced the Company's normalized net earnings by about \$12,000,000 or \$.37 per share.

Because of the warm winter, the Company also didn't realize much of the \$13.3 million annualized rate increase granted in Missouri last year. Under the September 2, 1998 rate order, our Missouri service territories were allowed a \$13.3 million revenue increase that was to be earned volumetrically. The Missouri rate order also accelerated the recovery

of certain Missouri Gas Energy safety program assets, which impacted earnings through increased depreciation expense.

But despite the warmer winter, we've dusted ourselves off and still experienced quite an exciting year. We look forward to welcoming our newest member to the Southern Union family – Pennsylvania Enterprises, Inc. (NYSE: PNT). We are excited about our new addition, which adds geographic and economic diversity to our operations and provides a significant presence in the northeastern United States. Pennsylvania Enterprises bolsters our goal of growth through intelligent acquisitions and mergers. We have also sought to enter the fast-growing southwestern United States market, however, ongoing litigation prevents our providing greater discussions about the gas company we have pursued in this region.

This past year, our employees have been especially enthusiastic about our company's future. We embarked on a new program that we've named “SUCCESS,” that gives them an arena for voicing their ideas about where our company should focus its direction. We expect to use their input as a springboard to develop our business ideas into a strategic plan. It is possible that any one of these ideas could evolve into a significant strategic focus in the future.

One focus from which we will not stray is our customer. We are dedicated to developing world-class customer service that will build loyalty among all our customers. Our goal is simple: Give the customer a low-cost, reliable supply of natural gas. And do it with a smile.

Which leads us to the smiles behind all of the initiatives that have been launched at Southern Union this past year – our employees. Their dedication to our company goals far surpasses expectations and their confidence in our future is demonstrated through the 91.3 percent of employees who are Southern Union stockholders. Their meticulous care at work spills over to their off-work hours in our communities, from blood drives and fund-raising walkathons to pitching in to help customers and neighbors who have

become victims of floods and natural disasters. It is especially gratifying to see their exuberance in all aspects of their lives.

Our enthusiasm this past year has led to other opportunities for our future:

- We began development of a workforce automation system that provides solutions to scheduling customer requests at their convenience while automatically recommending the most efficient workflow schedule for the service crew. This system also paves the way for online billing, payment and customer requests via the Internet.
- We developed plans to construct a pipeline across the Rio Grande River into Piedras Negras, Mexico, creating the opportunity to transport and become the primary supplier of natural gas to this rapidly growing market.
- We completed the implementation of the automated meter reading project at Missouri Gas Energy, resulting in a near-perfect accuracy rate on meter reads while virtually eliminating estimated bills.

As the millennium draws near we have a clear vision of our strategies. In the following pages, we've tried to sum up the issues critical to our success: acquisitions, growth, technology, employee development and, most importantly, our customers.

Let's move ahead!



George L. Lindemann  
Chairman of the Board &  
Chief Executive Officer



Peter H. Kelly  
President &  
Chief Operating Officer

SINCE THE DAYS OF KINGS AND QUEENS, CHESS HAS BEEN REGARDED AS A THINKER'S GAME, ONE THAT INVOLVES STRATEGY, AGGRESSIVENESS, AND ULTIMATELY, SUCCESS. ♟

THE CALCULATED MOVES. THE ANTICIPATION OF THE OTHER PLAYER'S ACTIONS. ♖ FROM THIS, MANY DRAW PARALLELS BETWEEN THE GAME OF CHESS AND THE STRATEGY OF BUSINESS. ♜ WHILE ENTERING THIS EXCITING ERA OF COMPETITION IN OUR INDUSTRY, WE ALSO ARE SCRUTINIZING OUR EVERY MOVE. ♟ AS WE CELEBRATE OUR 70TH ANNIVERSARY, WE ARE CONFIDENT THAT WE HAVE THE ADVANTAGE OVER OUR COMPETITORS. ♚ WE INVITE YOU TO FOLLOW OUR STRATEGY AS WE PLAN THESE MOVES. ♚

## PUT THE RIGHT PIECES IN PLACE



WHEN DISCUSSING “LUCK,” MANY PEOPLE TALK ABOUT “BEING IN THE RIGHT PLACE AT THE RIGHT TIME.” THOSE WHO ACCIDENTALLY FIND SUCCESS MAY SURELY HAVE LUCK AND GOOD FORTUNE TO THANK – BUT SUCCESS IS RARELY AN ACCIDENT. LIKE THE GRANDMASTER KNOWN FOR HIS STRATEGIC WIZARDRY, WINNERS POSITION THEMSELVES FOR SUCCESS. THEY PUT THE RIGHT PEOPLE IN THE RIGHT PLACE AT THE RIGHT TIME.

One of the strategic moves Southern Union made this year was actively seeking new ways to identify opportunities. We gave our employees a voice in the company’s direction while building their development skills through Southern Union Company Comprehensive Employee Success Strategy (SUCCESS). Just as each chess piece brings a unique capability to the board, each employee brings a unique combination of skill sets to the workplace. SUCCESS involves employees across the board bringing together their experiences and perspectives to identify potential opportunities.

Unlike the static nature of a chess piece, however, the beauty of people is that they evolve, learn, and change. Employees are not limited to one skill set, but encouraged to develop many. SUCCESS is transforming our workforce, giving bishops the skills of a knight, and knights the perspective of a bishop. Our employees attend creative-thinking workshops where they contribute provocative moves and ideas about how to better serve the customers.

A well-known student of the game once said it very simply: “Chess is imagination.” At Southern Union, our employees’ creativity is nurtured through new voices, new perspectives and new passions – and that’s what SUCCESS is all about.

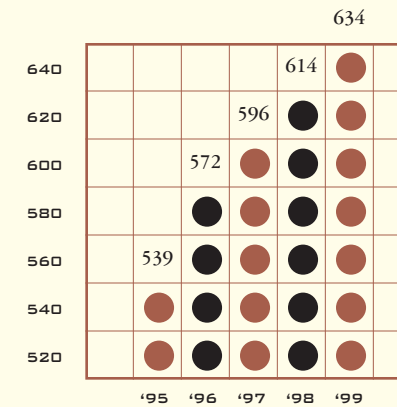
“[Chess teaches] foresight, by having to plan ahead; vigilance, by having to keep watch over the whole chess board; caution, by having to restrain ourselves from making hasty moves; and... [to] steadfastly continue searching for the solutions to our problems.”

– Benjamin Franklin in the first American article about chess published in *Columbian Magazine*, December 1786.

## PUT THE RIGHT PIECES IN PLACE



## CUSTOMERS SERVED PER EMPLOYEE



## GO, SEE, DO

Southern Union has utilized programs proven to be successful in companies with similar cultures such as the “Go, See, Do” program inspired by Southwest Airlines. In our version of the Go, See, Do program, employees are encouraged to step out of their normal job to become exposed to areas of the company that have little correlation to their immediate job responsibilities. For example, payroll analysts, data processors, network technicians, and others work side-by-side with servicepersons, dispatchers, meter readers, and pipefitters to walk the meter routes, locate lines, observe pipe repair, witness rate bearings, and examine propane use in homes. This process provides our employees the invaluable experience of what it is like to walk in other employees’ shoes and to continue a process of cross-pollination of ideas about how to improve customer service and make the operations more efficient.



## MAKE CONSISTENT ADVANCES



WHEN WORLD CHESS CHAMPION GARRY KASPAROV FIRST WENT UP AGAINST A COMPUTER IN A TWO-GAME MATCH IN 1989, HE CRUSHED THE TECHNOLOGICAL CONTENDER. BUT DEVELOPERS IMPROVED THE COMPUTER AND CREATED DEEP BLUE, A COMPUTER THAT EXAMINES AS MANY AS 200 MILLION FUTURE POSITIONS IN JUST ONE SECOND AND SEES AS MANY AS 30 BILLION POSITIONS WHILE DETERMINING THE NEXT MOVE. ULTIMATELY, KASPAROV'S TRIED-AND-TRUE METHODS WERE NO MATCH FOR TECHNOLOGY.

Like Kasparov, the utility industry has its own tried-and-true business practices. However, like Deep Blue, new technologies are appearing that will forever change the rules of the game. Those that employ these technologies wisely will overwhelm their competitors and create new traditions for a new world.

In fiscal 1999, we furthered Southern Union's move toward high-tech when we finalized installation of an Automated Meter Reading (AMR) system at our Missouri Gas Energy (MGE) division. The move was both a tactical and strategic breakthrough. Since installation, MGE has attained a near-perfect accuracy rate on meter reads and virtually eliminated "estimated" bills.

Currently, Southern Union is poised to achieve its next major technological advance: enhancing our workforce automation system. Southern Union has partnered with PointServe, a development company that customizes service delivery solutions. In the works is a system that will link "in-truck" computer terminals, the dispatch centers and call centers to optimize service call schedules. This system simultaneously analyzes a multitude of factors, such as customer need, employee skills, available equipment, and others, to create the most optimal service schedule. Responding to all service calls – even when unscheduled interruptions occur – in a shorter timeframe with the most efficient route, promises greater customer satisfaction. Using the PointServe system will result in providing customer service measured in hours rather than in half days.

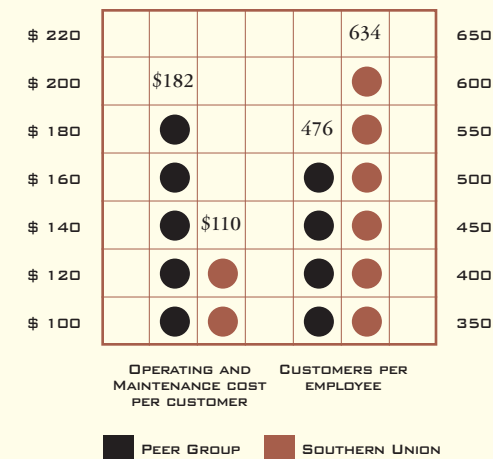
Even more exciting is the convenience the enhanced system will eventually give our customers: online access to billing information and history; online capability of scheduling preferred times for service calls and online payment – and with room to expand for new options. When these new customer interactive options are completed, Southern Union will join the ranks of only a few other utilities in the nation that offer online bill display and payment. That is what it is all about in a competitive marketplace – providing better service at a lower cost.

## MAKE CONSISTENT ADVANCES



## INDUSTRY EFFICIENCIES COMPARISON

Each peer group average is derived from the average of the Merrill Lynch Mid Cap LDC group, excluding Southern Union.



## MICROTURBINES CHURN WITH NATURAL GAS

*Wouldn't it be great if everyone had his own power source? It could happen. Through technological advances developed by Capstone Turbine Corporation, a "microturbine" fueled by natural gas or propane that produces electricity looks like the wave of the future. Southern Union has invested in the microturbine development company, which promises that a refrigerator-sized unit can provide nearly 30 kilowatts of electricity to a small business. For those with greater electric needs, the microturbines can be linked to generate even more capacity. Best of all, the units offer energy independence off the electric grid, or can be used as peak-shaving units that can help customers reduce their electric loads and lower their energy costs. On the electric grid or off, microturbines offer a flexible, reliable power source, even in remote locations. As a test, Southern Union installed a microturbine unit at our service center in Galveston, Texas. Faced with high humidity, heat and sea air, the unit has withstood intense weather conditions to provide reliable electricity powered by natural gas.*

"... [Southern Union] management is forward-looking in applying advanced technology in its regulated and unregulated businesses to improve efficiency and customer service."

Moody's Investors Service, November 1998



MAKE

CONSISTENT

ADVANCES

## PURSUE INTELLIGENT ACQUISITIONS



SOUTHERN UNION'S STRATEGY FOR LONG-TERM GROWTH INCLUDES ACQUIRING THE RIGHT PIECES THAT WILL POSITION THE COMPANY IN THE EVOLVING COMPETITIVE MARKETPLACE. SOUTHERN UNION EXECUTED AN EXCITING MOVE WITH ITS JUNE 7, 1999, ANNOUNCEMENT OF A MERGER WITH PENNSYLVANIA ENTERPRISES, INC. THIS ADDITION GIVES US A STRONG PRESENCE IN THE ATTRACTIVE NORTHEASTERN MARKET.

Pennsylvania Enterprises serves more than 152,000 natural gas distribution customers in northeastern and central Pennsylvania and also markets electricity to more than 20,000 customers through PG Energy PowerPlus. Pennsylvania Enterprises, a multifaceted energy business with regulated and nonregulated subsidiaries, will bring valuable expertise in the electric marketing business. This acquisition provides Southern Union both weather and economic diversification. Primarily using stock for this acquisition, Southern Union strengthens its balance sheet, providing a stronger base from which to continue to grow and meet our customers' needs. This merger places us in an advantageous position as we selectively seek utilities with growth opportunities.

Within the past few years, our growth strategy has resulted in Southern Union expanding into the Mexico and Florida gas utility markets as well as increasing our propane customer base in both Texas and Florida. Pennsylvania Enterprises' expanding propane business supports the effort to gain access to new customers by providing other energy options.

As we monitor our future moves, we will continue to consider other acquisitions – financially enhancing our growth and taking advantage of future market opportunities – while positioning ourselves for the next tactical move.

“Psychologically, you should have confidence in yourself and this confidence should be based on fact.”

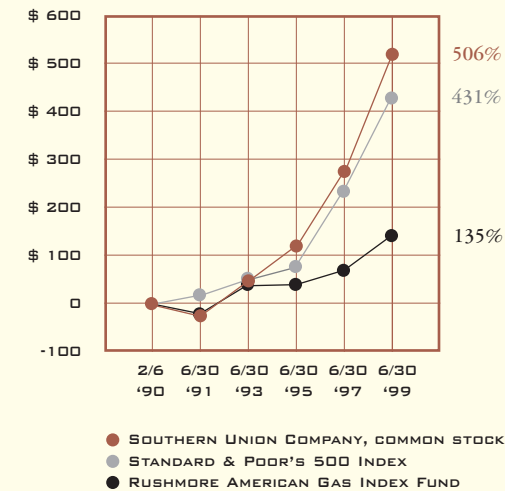
-- Robert J. Fischer

## PURSUE INTELLIGENT ACQUISITIONS



## COMPARATIVE TOTAL RETURN

Total return includes price appreciation plus gross dividends assumed to be reinvested in the same securities.



## JOUST WITH THE TAX-MAN

Unlike other utilities that typically pay out a significant portion of their earnings in cash dividends, Southern Union distributes an annual 5% common stock dividend. We distributed our sixth annual common stock dividend on August 6, 1999. This strategy allows Southern Union the financial flexibility to use its cash flow to enhance shareholder value. In receiving a stock dividend versus cash, our shareholders are effectively reinvesting in the company with pre-tax dollars, since income taxes are not recognized upon the payment of a stock dividend. The common stock dividend allows taxes to be deferred until the shareholder elects to sell the dividend, which is then eligible to be taxed at lower capital gain rates. For those shareholders subject to a state income tax, a stock dividend is even more beneficial as it results in a greater deferral of total tax.



PURSUE

INTELLIGENT

ACQUISITIONS

## RECOGNIZE OPPORTUNITIES



WHILE A MATCH IS IN PROGRESS, IT IS OFTEN IMPORTANT TO STEP BACK AND LOOK AT THE ENTIRE GAME BOARD. SOUTHERN UNION TAKES THAT APPROACH AS IT FOLLOWS A STRATEGY FOR MAXIMIZING SHAREHOLDER VALUE WHILE CAPITALIZING ON GROWTH FROM EXISTING PIECES. FROM THIS STANDPOINT, WE CAN BETTER DETERMINE THE PATH WE TAKE FOR GROWTH AND THE LIKELIHOOD OF ITS SUCCESS.

Southern Union's propane marketing subsidiary, SUPro Energy, uses a successful strategy of capturing developing propane markets. SUPro preserves these growing markets with an underground distribution system; SUPro teams up with subdivision developers to retain the services of affiliated division Southern Union Gas to install a pipeline grid system. The system will be ready for natural gas supply when the gas infrastructure reaches outlying areas of our existing distribution systems. Word of this successful program has created an increasing demand with SUPro's propane customer base growing 29 percent over the last year.

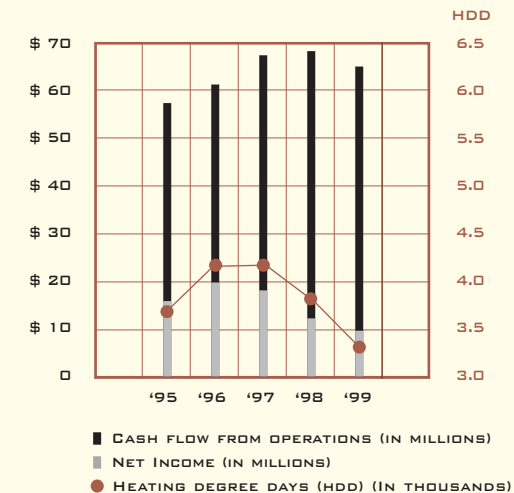
In another win-win situation, Southern Union has partnered with civic organizations in El Paso, Texas, to bring low-cost natural gas to the area's densely populated low-income development known as the Colonias. Typically lacking a basic utility infrastructure, residents pay disproportionately high rates for energy; the Colonias were in desperate need of low-cost energy. With Southern Union's investment in the Colonias, residents enjoy energy bills that dropped by more than 50 percent. And, because of the density, Southern Union benefits by adding customers at an investment that is usually 35 percent lower than average hookups.

Southern Union also made a strong opening in 1997 with a move to invest in a foreign natural gas distribution company in Mexico. Located in Piedras Negras, which is along the Texas-Mexico border, the company is in an expanding market that affords Southern Union and several of its subsidiaries significant growth opportunities. Pipeline subsidiary Southern Transmission Company plans to construct a connecting pipeline across the Rio Grande River, which will enable Southern Union's gas marketing subsidiary, Mercado Gas Services Inc., to provide cost efficient gas supply into this area of Mexico. Southern Union's companies will capture the opportunity of being the primary supply source to the Piedras Negras system, which is vital to support the future growth of the community.

RECOGNIZE

OPPORTUNITIES

## RECOGNIZE OPPORTUNITIES

CASH FLOW FROM OPERATING ACTIVITIES  
(BEFORE CHANGES IN WORKING CAPITAL)

“‘Tactics’ is knowing what to do when there is something to do; ‘strategy’ is knowing what to do when there is nothing to do.”

Savielly Tartakower, Chessmaster



## MARBRIDGE FOUNDATION BREEDS SAVINGS

*In the gentle rolling hills just outside Austin, Texas, a unique and important program helps adults with cognitive challenges carry on meaningful contributions to the community. Marbridge Foundation employs and houses more than 200 special individuals who help breed and raise champion-bloodline miniature horses and Texas longhorn cattle as well as help grow more than 16,000 poinsettias annually that brighten homes nationwide throughout the winter holiday season. Marbridge Foundation executives realized that in order to assure its continued existence, they needed a sound business operation – and that included curbing expenses. That's where SUPro Energy came into the picture. SUPro installed an underground propane loop system to the houses and work-site structures, delivering affordable and reliable propane energy from a central supply tank. The new system replaces the traditional use of individual tanks, significantly enhancing safety, and creates the infrastructure for the future supply of natural gas. As Marbridge Foundation helps challenged individuals learn how to earn a dollar, SUPro found a way to help the foundation save one.*



ALWAYS REMEMBER: THE CUSTOMER IS KING



IN **CHESS**, THE PRIMARY FOCUS IS THE KING. AT SOUTHERN UNION, OUR CUSTOMER IS THE KING. AS IN THE GAME, WE TAKE GREAT CARE OF OUR KINGS THROUGH WORLD-CLASS CUSTOMER SERVICE AND THE SAFE AND RELIABLE SUPPLY OF NATURAL GAS AT A LOW COST. WE RECOGNIZE THAT WHILE THE NATURAL GAS INDUSTRY STILL OPERATES IN A STAGE OF TRANSITION – THE REGULATED PRESENT AND THE COMPETITIVE FUTURE – OUR NEXT MOVE WILL BE TO SERVE OUR CUSTOMERS BETTER THAN EVER IN THE COMPETITIVE NEW WORLD OF CUSTOMER-CHOICE.

Southern Union believes there are four crucial pieces in a successful strategy within a competitive market: safety, reliability, *price*, and *customer service*. Safety and reliability are prerequisites – giving us the passage to compete. Price and customer service give us the large advantage to capture a win in a competitive environment.

To attest to our competitive, low-priced natural gas, Memphis Light, Gas and Water Division's Annual 1998 Utility Bill Comparison for 36 U.S. cities ranks El Paso, Texas, one of Southern Union's service communities, as the lowest cost natural gas provider in the country (as it has been in six of the last seven years).

Customer service – world-class customer service – is perhaps the most important, yet most difficult of the pieces to attain and maintain. We strive everyday to give quality service, timely call-center performance and courteous customer interactions. A recent customer satisfaction survey of our Missouri and Texas service areas conducted by Opinion Dynamics Corporation of Cambridge, Mass., noted that, "...all indications are that Southern Union Company is moving in the right direction with respect to customer satisfaction." The survey also revealed that "customer loyalty, a key indicator of customer satisfaction, ... has grown significantly."

All the more reason why we are dedicated to this fact – the customer is king.

ALWAYS

REMEMBER:

THE

KING

CUSTOMER

IS

ALWAYS REMEMBER: THE CUSTOMER IS KING



## RESIDENTIAL GAS BILLS

According to the Memphis Light, Gas and Water Division 1998 Utility Bill comparisons for selected U.S. cities, Southern Union Gas' El Paso service region continues to rank as the lowest cost natural gas provider. Of the 36 U.S. cities selected, based on size and geographic location, El Paso ranked as number one in each category – residential gas bills, commercial gas bills and industrial gas bills. The list below shows the top five utility companies in the residential bill category.

	CITY	UTILITY
1	EL PASO	SOUTHERN UNION GAS COMPANY
2	DENVER	PUBLIC SERVICE OF COLORADO
3	NEW ORLEANS	ENTERGY NEW ORLEANS, INC.
4	DETROIT	MICHCON
5	DALLAS	LONESTAR GAS COMPANY



## SMARTCHOICE MAKES A SMART MOVE

*The times, they are a changin'. Missouri Gas Energy (MGE) and Washington, D.C.-based Consumer Energy Council of America Research Foundation have teamed up on a new consumer education program called Missouri SmartChoice. In practice, SmartChoice provides an educational blueprint for MGE to work with neighborhood and civic groups, companies and others interested in discussing what they will need to know to make informed decisions about their energy suppliers when deregulation takes place. A March 1999 article, Managing Energy, in Kansas City business magazine "Ingrams," notes, "SmartChoice is one of the first educational programs of its kind in the nation. It's a savvy marketing move, too, on the part of the utility (MGE)." Changin' indeed. For the better.*

About Missouri SmartChoice...  
 "We're very supportive  
 that they're making this effort."

Bo Matisziw, Manager, Gas Department,  
 Missouri Public Service Commission,  
 Kansas City Star, Sept. 30, 1998.



SELECTED HISTORICAL FINANCIAL DATA

YEAR ENDED JUNE 30	1999	1998	1997	1996	1995
(DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)					
Operating revenues	\$ 605,231	\$ 669,304	\$ 717,031	\$ 620,391	\$ 479,983
Gas sales margin (revenues less gas costs)	\$ 262,930	\$ 263,724	\$ 267,843	\$ 258,852	\$ 238,144
Earnings from continuing operations	\$ 10,445	\$ 12,229	\$ 19,032	\$ 20,839	\$ 16,069
Earnings per common share - diluted	\$ 0.32	\$ 0.39	\$ 0.62	\$ 0.68	\$ 0.54
Return on average common equity	3.5%	4.3%	7.4%	8.8%	7.4%
Average domestic gas distribution customers served	998,476	979,186	955,838	952,934	947,691
Gas sales revenue:					
Residential	\$ 366,368	\$ 407,746	\$ 437,540	\$ 386,656	\$ 305,534
Commercial	\$ 140,871	\$ 159,187	\$ 175,076	\$ 154,193	\$ 119,213
Other	\$ 61,386	\$ 65,161	\$ 68,405	\$ 50,581	\$ 31,880
Total	\$ 568,625	\$ 632,094	\$ 681,021	\$ 591,430	\$ 456,627
Gas sales throughput - MMcf	105,156	115,270	121,996	118,454	104,458
Transportation revenues	\$ 20,144	\$ 19,664	\$ 21,073	\$ 19,307	\$ 16,714
Transportation throughput - MMcf	55,692	59,153	62,533	62,175	64,597
Total assets	\$ 1,087,348	\$ 1,047,764	\$ 990,403	\$ 964,460	\$ 992,597
Common stockholders' equity	\$ 301,058	\$ 296,834	\$ 267,462	\$ 245,915	\$ 225,664
Short-term debt and capital lease obligation	\$ 2,066	\$ 1,777	\$ 687	\$ 615	\$ 770
Long-term debt and capital lease obligation, less current portion	\$ 390,931	\$ 406,407	\$ 386,157	\$ 385,394	\$ 462,503
Preferred stock of subsidiary trust, \$25 par	\$ 100,000	\$ 100,000	\$ 100,000	\$ 100,000	\$ 100,000

IT TAKES AN AGGRESSIVE POSTURE TO WIN AND THEREBY PROTECT YOUR OWN KING.

 SOUTHERN UNION HAS ASSUMED THIS STANCE, ESPECIALLY AS THE CHALLENGE OF

COMPETITION COMES EVER CLOSER TO OUR GAME.  WITH COMPETITION, WE EXPECT

OTHER PLAYERS WILL VIE FOR OUR KING - THE CUSTOMER.  WE FEEL CONFIDENT

THAT WE HAVE ANTICIPATED THESE MOVES AND HAVE SET IN PLACE THE STRATEGIES

FOR PROTECTING OUR KINGS WHILE BOLDLY CAPTURING NEW KINGS.  OUR GAME

BOARD IS THE WORLD, WITH NO LIMITS AND ENDLESS POSSIBILITIES FOR NEW MOVES. 

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

**Overview** Southern Union Company's core business is the distribution of natural gas as a public utility through three divisions: Southern Union Gas, Missouri Gas Energy and Atlantic Utilities doing business as South Florida Natural Gas (SFNG). Southern Union Gas serves 513,000 customers in Texas (including the cities of Austin, Brownsville, El Paso, Galveston, Harlingen, McAllen and Port Arthur), Missouri Gas Energy serves 484,000 customers in central and western Missouri (including the cities of Kansas City, St. Joseph, Joplin and Monett) and SFNG, acquired as of December 31, 1997, serves 4,400 customers in portions of central Florida (including the cities of New Smyrna Beach, Edgewater and areas of Volusia County, Florida).

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 1999 (fiscal year ended June 30) net earnings were \$10,445,000 (\$.32 per common share, diluted for outstanding options and warrants — hereafter referred to as *per share*), compared with \$12,229,000 (\$.39 per share) in 1998. The decrease was primarily due to the extremely warm winter of 1998/1999, which was experienced in all of the Company's service territories. Weather in the Southern Union Gas service territories during 1999 was 25% warmer than 1998 while gas sales volumes in the corresponding period decreased 13%. Weather in the Missouri service territories during 1999 was 6% warmer than 1998 while gas sales volumes in the corresponding period decreased 10%. A \$13,300,000 annual rate increase, to be earned volumetrically, was granted by the MPSC to Missouri Gas Energy effective as of September 2, 1998. As a result of the volumetric nature of revenues and unusually warm weather, net earnings were only marginally impacted by the rate increase. The decrease in net earnings for 1999 is also attributed to \$3,839,000 of pre-tax costs associated with various acquisition efforts, impacting per share earnings by \$.07. Average common and common share equivalents outstanding increased 3.2% in 1999 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). The Company earned 3.5% on average common equity in 1999.

The Company's 1998 net earnings were \$12,229,000 (\$.39 per share), compared with \$19,032,000 (\$.62 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 Missouri Gas Energy. 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 Missouri Gas Energy 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 Missouri Gas Energy 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 previously discussed issuance of the Company's common stock on December 31, 1997 in connection with the acquisition of Atlantic. The Company earned 4.3% and 7.4% on average common equity in 1998 and 1997, respectively.

**Operating Revenues** Operating revenues in 1999 decreased \$64,073,000, or 10%, to \$605,231,000, while gas purchase costs decreased \$63,279,000, or 16%, to \$342,301,000.

Operating revenues and gas purchase costs in 1999 were affected by both a reduction in gas sales volumes and decreases in the cost of gas. Gas sales volumes decreased 9% in 1999 to 105,156 MMcf due to the significantly warmer winter weather in the Missouri and Texas 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 \$.26 to \$3.23 per Mcf in 1999 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 16% to \$1.88 per million British thermal units (MMBtu) in 1999.

Additionally impacting operating revenues in 1999 was a \$2,852,000 decrease in gross receipt taxes due to the mild weather in 1999. Gross receipt taxes are levied on sales revenues billed to the customers and remitted to the various taxing authorities. Operating revenues in 1999 compared with 1998 were also impacted by a \$1,200,000 decrease in revenues under a gas supply incentive plan approved by the MPSC in July, 1996. Under the plan, Southern Union and its Missouri customers share in certain savings below benchmark levels of gas costs incurred as a result of the Company's gas procurement activities. Operating revenues were favorably impacted by the \$13,300,000 annual increase to revenues granted to Missouri Gas Energy, effective as of September 2, 1998. However, as previously stated, the impact from this rate increase was marginal as it is earned volumetrically.

Gas purchase costs generally do not directly affect earnings since these costs are generally passed on to customers pursuant to purchase gas adjustment (PGA) 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 1999 decreased 3,461 MMcf to 55,692 MMcf at an average transportation rate per Mcf of \$.36 compared with \$.33 in 1998. Transportation volumes increased from 30,165 MMcf to 31,774 MMcf in 1999 for Missouri Gas Energy and decreased from 28,988 MMcf to 23,918 MMcf in 1999 for Southern Union Gas and the Company's pipe-line subsidiaries. This decrease was mainly caused by a 45% decrease, or 5,190 MMcf, in the amount of volumes transported into Mexico by Norteño Pipeline Company (Norteño), a subsidiary of the Company.

Operating revenues in 1998 compared with 1997 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 compared with 1997 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 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 Missouri Gas Energy, and decreased revenues of \$500,000 under the previously discussed gas supply incentive plan. Operating revenues were favorably impacted by an \$8,847,000 annual increase to revenues granted by the MPSC effective as of February 1, 1997.

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 Missouri Gas Energy 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.

In 1999 and 1998, the gas distribution operations in Texas contributed 29% and 32%, respectively, of the Company's consolidated operating revenues. In 1999 and 1998, the gas distribution operations in Missouri contributed 61% and 59%, respectively, of the Company's consolidated operating revenues. Four suppliers provided 50% and 45% of gas purchases in 1999 and 1998, respectively.

**Net Operating Margin** Net operating margin in 1999 (operating revenues less gas purchase costs and revenue related taxes) increased by \$2,058,000, compared with an increase of \$497,000, in 1998. Operating margins and earnings are primarily dependent upon gas sales volumes, gas service rates and timing of acquisitions. The level of gas sales volumes is sensitive to the variability of the weather. If normal weather had been present throughout the Company's service territories in 1999 and 1998, net operating margin would have increased by approximately \$20,334,000 and \$8,443,000, respectively. Texas and Missouri accounted for 40% and 55%, respectively, of the Company's net operating margin in 1999 and 43% and 52%, respectively, in 1998.

**Weather** Weather in the Missouri Gas Energy service territories in 1999 was 85% of a 30-year measure, 6% warmer than in 1998. Weather in the Southern Union Gas service territories in 1999 was 74% of a 30-year measure, 25% warmer than in 1998. Weather in Missouri in 1998 was 90% of a 30-year measure, 14% warmer than in 1997, while weather in Texas in 1998 was 99% of a 30-year measure, 8% colder than in 1997.

**Customers** The average number of customers served in 1999, 1998 and 1997 was 998,476, 979,186 and 955,838, respectively. These customer totals exclude Southern Union's 43% equity ownership in a natural gas distribution company in Piedras Negras, Mexico which currently serves 19,500 customers. Southern Union Gas served 507,517 customers in Texas during 1999. Missouri Gas Energy served 475,826 customers in central and western Missouri during 1999. SFNG and Atlantic Gas Corporation, a propane subsidiary of the Company, served 4,160 and 953 customers, respectively, during 1999. SUPro Energy Company (SUPro), a subsidiary of the Company, served 9,785 propane customers during 1999.

**Operating Expenses** Operating, maintenance and general expenses in 1999 increased \$2,166,000, or 2%, to \$109,693,000. The increase is a result of increased expenses associated with various claims and litigation and increases in employee benefit costs.

Depreciation and amortization expense in 1999 increased \$3,416,000 to \$41,855,000 as a result of including certain costs into rate base that were previously deferred as provided in the Missouri Gas Energy revenue increase effective as of September 2, 1998 and normal growth in plant. Taxes other than on income and revenues, principally consisting of property, payroll and state franchise taxes increased \$296,000 to \$14,501,000 in 1999. The increase was primarily due to increases in property taxes resulting from the inclusion of certain plant assets pursuant to the Missouri Gas Energy Safety Program that were previously deferred prior to the September 2, 1998 revenue increase in Missouri.

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 in reduced bad debt expense due to a reduction in delinquent customer accounts in 1998 compared with 1997. The significant increase in natural gas prices during 1997 caused many customers to receive considerably higher heating bills. Partially offsetting this factor was an increase in reserves for litigation claims and settlements in 1998 compared with 1997.

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 Missouri Gas Energy revenue increase effective as of February 1, 1997 and normal growth in plant. Taxes other than on income and revenues increased \$2,051,000 to \$14,205,000 in 1998. The increase was primarily due to increases in property taxes resulting from the inclusion of certain plant assets pursuant to the Missouri Gas Energy Safety Program that were deferred prior to the February 1, 1997 revenue increase in Missouri.

**Employees** The Company employed 1,554, 1,594 and 1,595 individuals as of June 30, 1999, 1998 and 1997, 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. In December 1998, the Company agreed to new five-year contracts with each bargaining-unit representing Missouri employees, which were effective in May 1999.

**Interest Expense and Dividends on Preferred Securities** Total interest expense in 1999 increased by \$1,115,000, or 3%, to \$35,999,000. Interest expense on long-term debt and capital leases increased by \$752,000 in 1999 primarily due to an increase of \$14,984,000 in the average capital lease obligation outstanding associated with the installation of an Automated Meter Reading (AMR) system at Missouri Gas Energy. The installation of the AMR system was completed during the first quarter of fiscal year 1999.

Interest expense on short-term debt in 1999 decreased \$849,000 to \$1,550,000 due to the average short-term debt outstanding during 1999 decreasing \$11,631,000 to \$27,474,000. The average rate of interest on short-term debt also decreased from 6.1% in 1998 to 5.6% in 1999. Interest expense incurred on PGA liabilities increased \$850,000 during 1999 due to lower than anticipated gas supply costs.

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 Missouri Gas Energy's capital lease obligation of \$22,151,000 incurred in 1998 for the installation of the 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.

**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, 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 by the Company of previously deferred costs in its fiscal year ended June 30, 1998. See *Commitments and Contingencies* in the Notes to Consolidated Financial Statements.

On August 21, 1998, Missouri Gas Energy was notified by the MPSC of its decision to grant a \$13,300,000 annual increase to revenue effective on September 2, 1998, which is primarily earned volumetrically. 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, the Company recorded this charge to earnings in its fiscal year ended June 30, 1998.

**Other Income (Expense), Net** Other expense, net, in 1999 was \$1,814,000, compared to other income, net, of \$4,073,000 in 1998. Other expense in 1999 included \$3,839,000 of costs associated with various acquisition efforts and a net expense of \$619,000 related to the amortization and current deferral of interest and other expenses associated with the Missouri Gas Energy Safety Program. This was partially offset by net rental income of Lavaca Realty Company (Lavaca Realty), the Company's real estate subsidiary, of \$1,448,000 and equity earnings of \$609,000 from Southern Union's 43% equity ownership of a natural gas distribution company in Piedras Negras, Mexico.

Other income in 1998 included \$1,671,000 in 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 of \$1,119,000. This was partially offset by \$885,000 of costs associated with various acquisition efforts.

Other income in 1997 included \$3,729,000 in 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 the payment of \$2,125,000 for the settlement with the Missouri Office of Public Counsel (OPC) and the MPSC for certain billing errors primarily from the 1996/1997 winter heating season; costs of \$1,750,000 associated with various acquisition efforts; and a \$257,000 donation of emissions analysis equipment and software to a Texas university.

**Federal and State Income Taxes** Federal and state income tax expense in 1999, 1998, and 1997 was \$7,109,000, \$7,984,000 and \$12,373,000, respectively. The decrease in income taxes during 1999 and 1998 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.

The Company's strategic plan is to increase the scale of its operations and the size of its customer base by pursuing and consummating future business combination transactions. The Company has entered into a merger agreement with Pennsylvania Enterprises, Inc. (PEI). See "Other Matters – Merger Agreement with Pennsylvania Enterprises, Inc." Acquisitions may require substantial financial expenditures that will need to be financed through cash flow from operations or future debt and equity offerings. The availability and terms of any such financing sources will depend upon various factors and conditions such as the Company's combined cash flow and earnings, the Company's resulting capital structure,

and conditions in financial markets at the time of such offerings. Acquisitions and financings will also affect the Company's combined results due to factors such as the Company's ability to realize any anticipated benefits from the PEI merger and any other acquisitions, successful integration of new and different operations and businesses, and effects of different regional economic and weather conditions. Future acquisitions may involve the issuance of shares of the Company's common stock, which could have a dilutive effect on the then-current stockholders of the Company. See "Other Matters – Cautionary Statement Regarding Forward-Looking Information."

Despite the abnormally warm weather, cash flow from operating activities in 1999 increased by \$8,596,000 to \$76,853,000, and increased by \$20,263,000 to \$68,257,000 in 1998. Operating activities were impacted by a reduction in net earnings in 1999 and 1998, 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, the timing of natural gas stored in inventory at Missouri Gas Energy and general changes in other operating accounts.

At June 30, 1999, 1998 and 1997, the Company's primary source of liquidity included borrowings available under the Company's credit facilities. A balance of \$21,000,000 and \$1,600,000 was outstanding under the credit facilities at June 30, 1999 and 1998, respectively. A balance of \$17,900,000 was outstanding under the facilities at July 31, 1999.

**Investing Activities** Cash flow used in investing activities in 1999 increased by \$15,575,000 to \$81,209,000, and increased by \$11,619,000 to \$65,634,000 in 1998. Investing activity cash flow was primarily affected by additions to property, plant and equipment, acquisition of operations and sales and purchases of investment securities.

During 1999, 1998 and 1997, the Company expended \$73,147,000, \$77,018,000 and \$64,463,000, respectively, for capital expenditures excluding acquisitions. These expenditures primarily related to distribution system replacement and expansion. Included in these capital expenditures were \$17,951,000, \$21,125,000 and \$20,972,000 for the Missouri Gas Energy Safety Program in 1999, 1998 and 1997, 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 for 755,650 pre-split and pre-stock dividend shares of common stock and \$4,436,000 of cash. On the date of acquisition, Atlantic had \$11,683,000 of cash and cash equivalents.

During 1999, the Company purchased investment securities of \$7,000,000. 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 \$5,363,000 in investment securities and had proceeds from the sale of investment securities of \$13,327,000. As of June 30, 1999, the investment securities are accounted for under the cost method.

The Company completed the installation of an AMR system at Missouri Gas Energy 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 June 30, 1999, the capital lease obligation outstanding was \$26,894,000.

**Financing Activities** Cash flow from financing activities was \$4,356,000 in 1999. Cash flow used in financing activities was \$2,623,000 in 1998, while cash flow from financing activities was \$3,134,000 in 1997. Financing activity cash flow changes were primarily due to repayment of debt, net borrowings under the revolving credit facilities and changes in cash overdrafts. As a result of these financing transactions, the Company's total debt to total capital ratio at June 30, 1999 was 49.0%, compared with 50.6% and 51.2% at June 30, 1998 and 1997, respectively. The Company's effective debt cost rate under the current debt structure is 7.7% (which includes interest and the amortization of debt issuance costs and redemption premiums on refinanced debt).

Southern Union Financing I, a consolidated wholly-owned subsidiary of Southern Union, issued \$100,000,000 of Preferred Securities in May 1995. 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.

In June 1999, the Company repurchased \$20,000,000 of Senior Notes. 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.

The Company has availability under two revolving credit facilities (Revolving Credit Facilities) underwritten by a syndicate of banks. Of the Revolving Credit Facilities, \$40,000,000 is available under a short-term facility which expires June 29, 2000, while \$60,000,000 is available under a long-term facility which expires June 30, 2002. 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. The Revolving Credit Facility is subject to a commitment fee based on the rating of the Senior Notes. As of June 30, 1999, 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 Company had standby letters of credit outstanding of \$1,622,000 at June 30, 1999 and \$2,947,000 at June 30, 1998, which guarantee payment of various insurance premiums and state taxes.

#### QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company has long-term debt, Preferred Securities and Revolving Credit Facilities, which subject the Company to the risk of loss associated with movements in market interest rates.

At June 30, 1999, the Company had issued fixed-rate long-term debt and Preferred Securities aggregating \$466,103,000 in principal amount and having a fair value of \$442,865,000. These instruments are fixed-rate and, therefore, do not expose the Company to the risk of earnings loss due to changes in market interest rates. However, the fair value of these instruments would increase by approximately \$22,832,000 if interest and dividend rates were to decline by 10% from their levels at June 30, 1999. In general, such an increase in fair value would impact earnings and cash flows only if the Company were to reacquire all or a portion of these instruments in the open market prior to their maturity.

The Company floating-rate obligations aggregated \$21,003,000 at June 30, 1999 primarily consisting of amounts borrowed under Revolving Credit Facilities of the Company. These floating-rate obligations expose the Company to the risk of increased interest expense in the event of increases in short-term interest rates. If the floating rates were to increase by 10% from June 30, 1999 levels, the Company's consolidated interest expense would increase by a total of approximately \$14,000 each month in which such increase continued.

The risk of an economic loss is mitigated at this time as a result of the Company's regulated status. Any unrealized gains or losses are accounted for in accordance with the Financial Accounting Standards Board *Accounting for the Effects of Certain Types of Regulation* as a regulatory asset/liability because the Company believes that its future contributions which are currently recovered through the rate-making process will be adjusted for these gains and losses.

The change in exposure to loss in earnings and cash flow related to interest rate risk from June 30, 1998 to June 30, 1999 is not material to the Company.

See *Preferred Securities of Subsidiary Trust* and *Debt and Capital Lease* in the Notes to the Consolidated Financial Statements.

#### OTHER MATTERS

**Merger Agreement with Pennsylvania Enterprises, Inc.** On June 7, 1999, Southern Union and Pennsylvania Enterprises, Inc. announced a definitive merger agreement. The agreement calls for PEI to merge into Southern Union in a transaction valued at approximately \$500 million, including assumption of debt. If approved, each PEI shareholder will receive Southern Union common stock having a value of \$32.00, plus \$3.00 in cash, subject to adjustment. PEI is a multifaceted energy company headquartered in Wilkes-Barre, Pennsylvania, with natural gas distribution being its primary business. PEI's principal subsidiary, PG Energy, together with Honesdale Gas Company serve more than 152,000 gas customers in north-eastern and central Pennsylvania. In addition, PEI markets electricity to more than 20,000 customers through PG Energy power Plus. Southern Union anticipates having shareholder and all regulatory approvals for this merger in the second quarter of the Company's fiscal year 2000.

The amount of Southern Union common stock to be issued in connection with the PEI merger and cash to be paid to PEI's stockholders may vary as a result of fluctuations in the price of the Company's common stock. Management anticipates that substantially all of the cash portion of the merger consideration to be paid to PEI's stockholders under the merger agreement and other merger-related costs (approximately \$35 to \$55 million) will be financed through external sources. In addition, the Company anticipates refinancing substantially all of the current portion of outstanding long-term debt of PEI and its subsidiaries, and the preferred stock of a PEI subsidiary in connection with or soon after completion of the PEI merger. Sources of financing may include commercial and investment banks, institutional lenders and investors, and the public securities markets. Management believes that the Company will have access to many sources and types of short-term and long-term capital financing; however, the terms of such financing or refinancing arrangements may contain covenants that could adversely affect the financial condition and flexibility of the Company.

**Propane Operations** SUPro and Atlantic Gas Corporation currently serve 11,000 and 1,100 customers, respectively. These propane operations sold 7,293,000 and 5,758,000 gallons of propane during 1999 and 1998, respectively.

**Foreign Operations** On July 23, 1997, Energía 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 an equity ownership in a natural gas distribution company and other operations which currently serves 19,500 customers in Piedras Negras, Mexico, which is across the border from the Company's Eagle Pass, Texas service area. Southern Union currently has a 43% equity ownership in this company. On September 8, 1997, Southern Transmission Company, another subsidiary of the Company, purchased a 45-mile intrastate pipeline for \$305,000 which augments 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 1999 and 1998.

**Stock Splits and Dividends** On August 6, 1999 and December 9, 1998, Southern Union distributed its annual 5% common stock dividend to stockholders of record on July 23, 1999 and November 23, 1998. A portion of each of these 5% stock dividends 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. Additionally, Southern Union distributed an annual 5% common stock dividend on December 10, 1997. On July 13, 1998, a three-for-two stock split was distributed in the form of a 50% stock dividend. 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 split and stock dividends.

**Contingencies** The Company assumed responsibility for certain environmental matters in connection with the acquisition of Missouri Gas Energy. 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 February 1, 1999, Southern Union submitted a proposal to the Board of Directors of Southwest Gas Corporation (Southwest) to acquire all of Southwest's outstanding common stock for \$32.00 per share. Southwest then had a pending merger agreement with ONEOK, Inc. (ONEOK) at \$28.50 per share. On February 22, 1999, Southern Union and Southwest both publicly announced Southern Union's proposal, after the Southwest Board of Directors determined that Southern Union's proposal was a Superior Proposal (as defined in the Southwest merger agreement with ONEOK). At that time Southern Union entered into a Confidentiality and Standstill Agreement with Southwest at Southwest's insistence. On April 25, 1999, Southwest's 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 shareholders with a 6% annual rate of return on its \$33.50 offer, commencing February 15, 2000, until closing. According to public statements by Southwest, Southern Union's revised proposal has also been rejected by Southwest's Board of Directors.

There are four lawsuits pending that relate to activities surrounding Southern Union's efforts to acquire Southwest. In addition, there is before the U. S. Court of Appeals for the Tenth Circuit, an appeal by Southern Union of a preliminary injunction entered by the U.S. District Court for the Northern District of Oklahoma. Southern Union intends to vigorously pursue its claims against Southwest, ONEOK, and certain individual defendants, and vigorously defend itself against

the claims by Southwest and ONEOK. See *Commitments and Contingencies* in the Notes to Consolidated Financial Statements for a discussion of these lawsuits.

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 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 that the outcome of this matter will not have a material adverse impact on the Company's results of operations, financial position or cash flows. 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 State 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 Missouri Gas Energy 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 sought a transfer of the case to the Missouri Supreme Court which was denied on November 24, 1998.

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 service rates in relation to the increasing cost of providing service and the inherent regulatory lag in adjusting those 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 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 Missouri Gas Energy totaling \$1,575,000 to those customers overbilled and a \$550,000 contribution by Missouri Gas Energy to a social service organization for the express purpose of assisting needy Missouri Gas Energy customers in paying their gas bills. These balances were recorded as of June 30, 1997.

In August 1997, the MPSC issued an order authorizing Missouri Gas Energy to begin making semi-annual PGAs in November and April, instead of more frequent adjustments as previously made. Additionally, the order authorized Missouri Gas Energy 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 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 years ended June 30, 1999, 1998 and 1997, the incentive plan achieved a reduction of overall gas costs of \$6,900,000, \$9,200,000 and \$10,200,000, respectively, resulting in savings to Missouri customers of \$4,000,000, \$5,100,000 and \$5,600,000, respectively. The Company recorded revenues of \$2,900,000, \$4,100,000 and \$4,600,000 in 1999, 1998 and 1997, respectively under this plan. Missouri Gas Energy is currently working with the MPSC to develop an alternate plan due to the July 1, 1999 expiration of the experimental gas supply incentive plan; however, there can be no assurance that this or any similar plan will be approved by the MPSC for Missouri Gas Energy.

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. On May 21, 1998, Southern Union Gas filed with the Railroad Commission of Texas (RRC) 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. On December 21, 1998, the RRC issued its order implementing an \$884,000 one-time cost of gas refund and a \$99,000 base rate reduction. The cost of gas refund was completed in February 1999.

On August 21, 1998, Missouri Gas Energy 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 Missouri Gas Energy requested a rehearing on significant portions of these disallowances. On December 8, 1998, the MPSC denied rehearing requests made by all parties other than Missouri Gas Energy and granted a portion of Missouri Gas Energy's rehearing request. The MPSC will conduct further proceedings to take additional evidence on those matters for which it granted Missouri Gas Energy a rehearing. If the MPSC adopts Missouri Gas Energy's positions on rehearing, then Missouri Gas Energy would be authorized an additional \$2,200,000 of base

revenues increasing 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 Missouri Gas Energy's authorized base revenue increase on judicial review, Missouri Gas Energy expects such arguments to be unsuccessful.

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 as of February 1, 1997. Southern Union Gas also received several annual cost of service adjustments in 1999, 1998 and 1997. See *Utility Regulation and Rates* and *Commitments and Contingencies* in the 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 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 Missouri Gas Energy Safety Program will result in significant levels of future capital expenditures. The Company estimates incurring capital expenditures of \$14,372,000 in fiscal 2000 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 monthly fixed service charges. Southern Union Gas has weather normalization clauses in the City of Austin, El Paso environs, 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 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, assessment and testing phases regarding application systems, process control systems and technology infrastructure, and is performing renovations and repairs in each of these categories. The Company's renovation and repair efforts are substantially complete. Validation and confirmation testing of affected areas will continue through calendar year 1999. The review of critical business partners, gas transporters and suppliers is in the assessment stage and the Company will continue to confirm the readiness of these third parties 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 has incurred costs to date on this project of approximately \$2,000,000. The Company expects to spend approximately \$6,500,000 for these Year 2000 readiness efforts. Included in this estimate are equipment leasing expenses of approximately \$1,500,000 that will be incurred over the life of the equipment. Also included in this estimate are costs associated with contingency planning, software licensing and consulting expenses that will be incurred prior to the end of 1999. 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 and Year 2000 testing has established that these programs are now 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 developed a contingency plan in the event that supplier or internal operational failures do occur and that plan is being implemented throughout the Company. 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.

**Accounting Pronouncements** In June 1998, the Financial Accounting Standards Board issued *Accounting for Derivative Instruments and Hedging Activities*, as amended, is required to be adopted by the Company on July 1, 2000. 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.

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; the impact of any Year 2000 disruption; 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.

**CONSOLIDATED STATEMENT OF OPERATIONS**

YEAR ENDED JUNE 30	1999	1998	1997
	(THOUSANDS OF DOLLARS EXCEPT SHARES AND PER SHARE AMOUNTS)		
Operating revenues	\$ 605,231	\$ 669,304	\$ 717,031
Gas purchase costs	342,301	405,580	449,188
Operating margin	262,930	263,724	267,843
Revenue related taxes	(32,034)	(34,886)	(39,502)
Net operating margin	230,896	228,838	228,341
Operating expenses:			
Operating, maintenance and general	109,693	107,527	109,888
Depreciation and amortization	41,855	38,439	34,829
Taxes, other than on income and revenues	14,501	14,205	12,154
Total operating expenses	166,049	160,171	156,871
Net operating revenues	64,847	68,667	71,470
Other income (expense):			
Interest	(35,999)	(34,884)	(33,465)
Dividends on preferred securities of subsidiary trust	(9,480)	(9,480)	(9,480)
Write-off of regulatory assets	-	(8,163)	-
Other, net	(1,814)	4,073	2,880
Total other expenses, net	(47,293)	(48,454)	(40,065)
Earnings before income taxes	17,554	20,213	31,405
Federal and state income taxes	7,109	7,984	12,373
NET EARNINGS AVAILABLE FOR COMMON STOCK	\$ 10,445	\$ 12,229	\$ 19,032
NET EARNINGS PER SHARE:			
Basic	\$ .34	\$ .40	\$ .64
Diluted	\$ .32	\$ .39	\$ .62
WEIGHTED AVERAGE SHARES OUTSTANDING:			
Basic	30,894,613	30,406,832	29,641,523
Diluted	32,589,610	31,591,811	30,812,248

SEE ACCOMPANYING NOTES.

**CONSOLIDATED BALANCE SHEET-ASSETS**

JUNE 30	1999	1998
	(THOUSANDS OF DOLLARS)	
<b>PROPERTY, PLANT AND EQUIPMENT:</b>		
Plant in service	\$ 1,106,905	\$ 1,057,675
Construction work in progress	13,271	7,783
	1,120,176	1,065,458
Less accumulated depreciation and amortization	(376,212)	(355,430)
	743,964	710,028
Additional purchase cost assigned to utility plant, net of accumulated amortization of \$31,115,000 and \$27,030,000, respectively	134,296	138,381
	878,260	848,409
<b>CURRENT ASSETS:</b>		
Accounts receivable, billed and unbilled, net	50,693	53,760
Inventories, principally at average cost	29,373	26,160
Prepayments and other	4,692	4,747
	84,758	84,667
Deferred charges	96,635	94,550
Investment securities	12,000	5,000
Real estate	9,420	9,741
Other	6,275	5,397
<b>TOTAL ASSETS</b>	<b>\$ 1,087,348</b>	<b>\$ 1,047,764</b>

SEE ACCOMPANYING NOTES.

**CONSOLIDATED BALANCE SHEET-STOCKHOLDERS' EQUITY AND LIABILITIES**

JUNE 30	1999	1998
	(THOUSANDS OF DOLLARS)	
<b>COMMON STOCKHOLDERS' EQUITY:</b>		
Common stock, \$1 par value; authorized 50,000,000 shares; issued 31,239,662 (including 1,484,988 shares issued on August 6, 1999 as a stock dividend) shares at June 30, 1999	\$ 31,240	\$ 28,252
Premium on capital stock	276,610	252,638
Less treasury stock: 51,625 shares at cost	(794)	(794)
Less common stock held in trust: 268,513 shares	(5,562)	-
Accumulated other comprehensive income	(436)	-
Retained earnings	-	16,738
	301,058	296,834
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	390,931	406,407
<b>Total capitalization</b>	<b>791,989</b>	<b>803,241</b>
<b>CURRENT LIABILITIES:</b>		
Long-term debt and capital lease obligation due within one year	2,066	1,777
Notes payable	21,003	1,600
Accounts payable	37,834	26,570
Federal, state and local taxes	13,300	14,017
Accrued interest	12,176	12,699
Customer deposits	17,682	17,686
Deferred gas purchases	22,955	12,257
Other	16,612	21,095
<b>Total current liabilities</b>	<b>143,628</b>	<b>107,701</b>
Deferred credits and other	81,493	74,217
Accumulated deferred income taxes	70,238	62,605
Commitments and contingencies	-	-
<b>TOTAL STOCKHOLDERS' EQUITY AND LIABILITIES</b>	<b>\$ 1,087,348</b>	<b>\$ 1,047,764</b>

SEE ACCOMPANYING NOTES.

CONSOLIDATED STATEMENT OF CASH FLOWS

YEAR ENDED JUNE 30	1999	1998	1997
	(THOUSANDS OF DOLLARS)		
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net earnings	\$ 10,445	\$ 12,229	\$ 19,032
Adjustments to reconcile net earnings to net cash flows from operating activities:			
Depreciation and amortization	41,855	38,439	34,829
Deferred income taxes	7,867	6,363	7,340
Provision for bad debts	3,279	5,461	11,298
Write-off of regulatory assets	—	8,163	—
Deferred interest expense	619	(1,671)	(3,729)
Gain on sale of investment securities	—	(1,088)	(2,545)
Other	1,004	1,447	1,077
Changes in assets and liabilities, net of acquisitions:			
Accounts receivable, billed and unbilled	(212)	132	(22,111)
Accounts payable	5,228	(7,066)	(6,978)
Taxes and other liabilities	(1,240)	146	(2,975)
Customer deposits	(4)	201	1,558
Deferred gas purchases	10,698	8,693	6,215
Inventories	(3,213)	(4,361)	5,691
Other	527	1,169	(708)
<b>Net cash flows from operating activities</b>	<b>76,853</b>	<b>68,257</b>	<b>47,994</b>

CONSOLIDATED STATEMENT OF CASH FLOWS-CONTINUED

YEAR ENDED JUNE 30	1999	1998	1997
	(THOUSANDS OF DOLLARS)		
<b>CASH FLOWS FROM (USED IN) INVESTING ACTIVITIES:</b>			
Additions to property, plant and equipment	\$ (73,147)	\$ (77,018)	\$ (64,463)
Acquisition of operations, net of cash received	—	6,502	(1,861)
Purchase of investment securities	(7,000)	(5,000)	(5,363)
Increase in customer advances	2,139	3,562	2,470
Increase (decrease) in deferred charges and credits	(4,086)	(1,786)	6
Proceeds from sale of land	—	—	1,096
Proceeds from sale of investment securities	—	6,531	13,327
Other	885	1,575	773
<b>Net cash flows used in investing activities</b>	<b>(81,209)</b>	<b>(65,634)</b>	<b>(54,015)</b>
<b>CASH FLOWS FROM (USED IN) FINANCING ACTIVITIES:</b>			
Repayment of debt and capital lease obligation	(20,837)	(1,309)	(640)
Net borrowings under revolving credit facilities	19,403	—	1,600
Increase (decrease) in cash overdrafts	6,033	(945)	1,567
Other	(243)	(369)	607
<b>Net cash flows from (used in) financing activities</b>	<b>4,356</b>	<b>(2,623)</b>	<b>3,134</b>
<b>DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>—</b>	<b>—</b>	<b>(2,887)</b>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR</b>	<b>—</b>	<b>—</b>	<b>2,887</b>
<b>CASH AND CASH EQUIVALENTS AT END OF YEAR</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ —</b>

Cash paid for interest, net amounts capitalized, in 1999, 1998 and 1997 was \$45,039,000, \$33,997,000 and \$32,282,000, respectively. Cash paid for income taxes in 1999, 1998 and 1997 was \$1,194,000, \$4,511,000 and \$5,871,000, respectively.

SEE ACCOMPANYING NOTES.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

	COMMON STOCK, \$1 PAR VALUE	PREMIUM ON CAPITAL STOCK	TREASURY STOCK AND OTHER	ACCUMULATED OTHER COMPREHENSIVE INCOME	RETAINED EARNINGS	TOTAL
(THOUSANDS OF DOLLARS)						
Balance July 1, 1996	\$ 16,275	\$ 206,047	\$ (794)	\$ (1,244)	\$ 25,631	\$ 245,915
Comprehensive income:						
Net earnings	—	—	—	—	19,032	19,032
Unrealized holding gain, net of tax and reclassification adjustment	—	—	—	1,908	—	1,908
Comprehensive income						20,940
5% stock dividend	813	18,681	—	—	(19,494)	—
Exercise of stock options	83	524	—	—	—	607
Balance June 30, 1997	17,171	225,252	(794)	664	25,169	267,462
Comprehensive income:						
Net earnings	—	—	—	—	12,229	12,229
Reclassification adjustment for gains included in net income	—	—	—	(664)	—	(664)
Comprehensive income						11,565
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
Exercise of stock options	69	(301)	—	—	—	(232)
Balance June 30, 1998	28,252	252,638	(794)	—	16,738	296,834
Comprehensive income:						
Net earnings	—	—	—	—	10,445	10,445
Minimum pension liability adjustment; net of tax	—	—	—	(436)	—	(436)
Comprehensive income						10,009
Common stock held in trust	—	—	(5,562)	—	—	(5,562)
5% stock dividend—declared						
November 11, 1998	1,411	7,483	—	—	(8,898)	(4)
5% stock dividend—declared						
July 13, 1999	1,485	16,797	—	—	(18,285)	(3)
Exercise of stock options	92	(308)	—	—	—	(216)
<b>BALANCE JUNE 30, 1999</b>	<b>\$ 31,240</b>	<b>\$ 276,610</b>	<b>\$ (6,356)</b>	<b>\$ (436)</b>	<b>\$ —</b>	<b>\$ 301,058</b>

SEE ACCOMPANYING NOTES.

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 located primarily in Texas and Missouri. 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. Investments in which the Company owns a 20% to 50% interest are accounted for using the equity method. 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 and revenue taxes are matched with cycle-billed revenues through utilization 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 1999, 1998 and 1997. Four suppliers provided 50%, 45% and 44% of the Company's gas purchases in 1999, 1998 and 1997, respectively.

**Earnings Per Share** The Company's earnings per share presentation conforms to the Financial Accounting Standards Board (FASB) standard, *Earnings per Share*. All share and per share data have been restated for all stock dividends and stock splits unless otherwise noted.

**Accumulated Other Comprehensive Income** In 1999, the Company adopted *Reporting Comprehensive Income*, a FASB standard which established rules for the reporting of comprehensive income and its components. The main components of comprehensive income that relate to the Company are net earnings, unrealized holding gains on investments and additional minimum pension liability adjustments, all of which are presented in the consolidated statement of stockholders' equity. Prior to adoption, the unrealized holding gains were presented as part of stockholders' equity and the pension liability adjustments were presented in the consolidated balance sheet.

Unrealized holding gains on investment securities were nil, nil and \$3,562,000 in 1999, 1998 and 1997, respectively. The reclassification adjustment for gains included in net income, net of tax, for reporting other comprehensive income was nil, \$664,000 and \$1,654,000 in 1999, 1998 and 1997, respectively. The unrealized holding gains on investment securities and the reclassification adjustment for gains are combined and reflected on the consolidated statement of stockholders' equity.

**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 \$6,588,000, \$8,267,000, \$10,765,000 and \$3,779,000 at June 30, 1999, 1998, 1997 and 1996, 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 accounts receivable, accounts payable and notes payable approximate their fair value. The fair value of the Company's preferred securities of subsidiary trust 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 \$23,680,000 and \$20,545,000 at June 30, 1999 and 1998, respectively, consists of 10,429,000 and 9,118,000 British thermal units, respectively.

**Segment Reporting** The FASB standard, *Disclosures about Segments of an Enterprise and Related Information*, requires disclosure of segment data based on how management makes decisions about allocating resources to segments and measuring performance. The Company is principally engaged in the gas distribution industry in the United States and has no other reportable industry segments.

**New Pronouncements** In June 1998, the Financial Accounting Standards Board issued *Accounting for Derivative Instruments and Hedging Activities*, as amended, is required to be adopted by the Company on July 1, 2000. 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.

**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

On June 7, 1999, Southern Union and Pennsylvania Enterprises, Inc. (PEI) announced a definitive merger agreement. The agreement calls for PEI to merge into Southern Union in a transaction valued at approximately \$500 million, including assumption of debt of approximately \$150 million. If approved, each PEI shareholder will receive Southern Union common stock having a value of \$32.00, plus \$3.00 in cash, subject to adjustment. PEI is a multifaceted energy company headquartered in Wilkes-Barre, Pennsylvania with natural gas distribution being its primary business. PEI's principal subsidiary, PG Energy, together with Honesdale Gas Company serve more than 152,000 gas customers in northeastern and central Pennsylvania. In addition, PEI markets electricity to more than 20,000 customers through PG Energy Power Plus. Southern Union anticipates having shareholder and all regulatory approvals for this merger in the second quarter of the Company's fiscal year 2000.

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 \$4,436,000 of cash. 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 5,500 customers in central Florida. The assets of Atlantic were included in the Company's consolidated balance sheet at January 1, 1998 and its 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 \$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 an equity ownership in a natural gas distribution company and other related operations currently serving 19,500 customers in Piedras Negras, Mexico for \$2,700,000. Southern Union currently has a 43% equity ownership in this company. 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 augments 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.

## 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, a division of the Company, 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 by the Company of previously deferred costs in its fiscal year ended 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. The Company recorded this charge to earnings in its fiscal year ended June 30, 1998. See *Utility Regulation and Rates*.

## IV OTHER INCOME (EXPENSE), NET

Other expense of \$1,814,000 in 1999 included: \$3,839,000 of costs associated with various acquisition efforts and a net expense of \$619,000 related to the amortization and current deferral of interest and other expenses associated with the Missouri Gas Energy Safety Program. This was partially offset by net rental income of Lavaca Realty Company (Lavaca Realty), the Company's real estate subsidiary, of \$1,448,000 and equity earnings of \$609,000 from Southern Union's 43% equity ownership of a natural gas distribution company in Piedras Negras, Mexico.

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 of \$1,119,000. This was partially offset by \$885,000 of costs associated with various acquisition efforts.

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 the payment of \$2,125,000 for the settlement with the Missouri Office of Public Counsel and the MPSC for certain billing errors primarily from the 1996/1997 winter heating season; costs of \$1,750,000 associated with various acquisition efforts; and a \$257,000 donation of emissions analysis equipment and software to a Texas university.

## 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, 1999, 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 30,894,613, 30,406,832 and 29,641,523 for the years ended June 30, 1999, 1998 and 1997, respectively. Diluted earnings per share includes average shares outstanding as well as common stock equivalents from stock options and warrants. Common stock equivalents were 1,694,997, 1,184,979 and 1,170,725 for the years ended June 30, 1999, 1998 and 1997, respectively.

## VII PROPERTY, PLANT AND EQUIPMENT

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	1999	1998
Distribution plant	\$ 1,033,281	\$ 984,580
General plant	109,178	106,444
Other	16,648	16,172
Total plant	1,159,107	1,107,196
Less contributions in aid of construction	(52,202)	(49,521)
Plant in service	1,106,905	1,057,675
Construction work in progress	13,271	7,783
	1,120,176	1,065,458
Less accumulated depreciation and amortization	(376,212)	(355,430)
	743,964	710,028
Additional purchase cost assigned to utility plant, net	134,296	138,381
	\$ 878,260	\$ 848,409

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 was indicated or expected at June 30, 1999.

**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 1999, 1998, and 1997 was \$37,771,000, \$34,477,000 and \$31,051,000, respectively.

## VIII INVESTMENT SECURITIES

At June 30, 1999 and 1998, all securities owned by the Company are accounted for under the cost method. These securities consist of preferred stock in non-public companies whose value is not readily determinable. 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.

## IX STOCKHOLDERS' EQUITY

**Stock Splits and Dividends** On August 6, 1999, December 9, 1998, December 10, 1997 and December 10, 1996, Southern Union distributed its annual 5% common stock dividend to stockholders of record on July 23, 1999, November 23, 1998, November 21, 1997 and November 22, 1996, respectively. A portion of the 5% stock dividend distributed on August 6, 1999 and December 9, 1998 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. Unless otherwise stated, all per share and share data included herein have been restated to give effect to the dividends and split. The 5% common stock dividend declared on July 13, 1999, is reflected in the Consolidated Balance Sheet at June 30, 1999.

**Common Stock** The Company maintains its 1992 Long-Term Stock Incentive Plan (1992 Plan) under which options to purchase 3,653,343 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 1999, 1998 and 1997. 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 \$9,429,000 and \$.29, respectively, in 1999, \$11,141,000 and \$.35, respectively, in 1998 and \$18,489,000 and \$.60, respectively, in 1997. 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.

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 and 1997, respectively: dividend yield of nil for both years; volatility of 19.5% and 21%; risk-free interest rate of 5.5% and 6.2%; and expected life outstanding of 5.5 to 7.2 years for both years. There were no options granted during 1999.

	1992 PLAN		1982 PLAN	
	SHARES UNDER OPTION	WEIGHTED AVERAGE EXERCISE PRICE	SHARES UNDER OPTION	WEIGHTED AVERAGE EXERCISE PRICE
Outstanding July 1, 1996	1,526,150	\$ 6.53	539,592	\$ 3.08
Granted	491,974	13.12	-	-
Exercised	(61,182)	5.68	(85,612)	3.08
Canceled	(13,162)	6.58	-	-
Outstanding June 30, 1997	1,943,780	8.23	453,980	3.08
Granted	743,710	16.93	-	-
Exercised	(84,983)	4.48	(89,258)	3.08
Canceled	(21,634)	12.58	-	-
Outstanding June 30, 1998	2,580,873	10.82	364,722	3.08
Exercised	(107,785)	6.41	(41,706)	3.09
Canceled	(42,302)	14.93	-	-
Outstanding June 30, 1999	2,430,786	10.94	323,016	3.08

The following table summarizes information about stock options outstanding under the 1992 Plan at June 30, 1999:

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	372,261	3.3 years	\$ 3.87	372,261	\$ 3.87
5.01 - 10.00	871,582	5.1 years	7.88	659,361	7.63
10.01 - 15.00	457,926	7.8 years	13.04	187,620	13.01
15.01 - 20.00	729,017	8.8 years	16.89	139,250	16.93
	<u>2,430,786</u>			<u>1,358,492</u>	

The shares exercisable under the 1992 Plan and the corresponding weighted average exercise price at June 30, 1999, 1998 and 1997 were 1,358,492 and \$8.29; 1,032,594 and \$6.57; and 756,974 and \$5.55, respectively. The shares exercisable under the 1982 Plan and the corresponding weighted average exercise price at June 30, 1999, 1998 and 1997 were 323,016 and \$3.08; 364,722 and \$3.08; and 453,980 and \$3.08, respectively. The weighted average remaining contractual life of options outstanding under the 1982 Plan at June 30, 1999 was 0.9 years. There were 889,792 shares available for future option grants under the 1992 Plan at June 30, 1999. No shares were available for future option grants under the 1982 Plan at June 30, 1999.

On February 10, 1994, Southern Union granted a warrant which expires on February 10, 2004, to purchase up to 100,506 shares of Common Stock at an exercise price of \$6.90 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 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, 1999, the quoted market price per Preferred Security was \$25.38. As of June 30, 1999 and 1998, 4,000,000 shares of Preferred Securities were outstanding.

#### XI DEBT AND CAPITAL LEASE

JUNE 30	1999	1998
7.60% Senior Notes, due 2024	\$ 364,515	\$ 384,515
Capital lease and other	28,482	23,669
Total long-term debt	<u>\$ 392,997</u>	<u>\$ 408,184</u>

The maturities of long-term debt and capital lease payments for each of the next five years ending June 30 are: 2000 - \$2,066,000; 2001 - \$2,188,000; 2002 - \$2,330,000; 2003 - \$12,660,000; 2004 - \$8,849,000 and thereafter - \$364,904,000.

**Senior Notes** On January 31, 1994, Southern Union completed the sale of the 7.60% Senior Debt Securities (Senior Notes). During 1999, \$20,000,000 of Senior Notes were repurchased at \$941 per \$1,000 note resulting in a net pre-tax gain of \$425,000, net of related debt expense. 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 \$936 and \$895 (per \$1,000 note) on June 30 and July 31, 1999, respectively, as quoted by a major brokerage firm. The carrying amount of long-term debt at June 30, 1999 and 1998 was \$392,997,000 and \$408,184,000, respectively. The fair value of long-term debt at June 30, 1999 and 1998 was \$369,759,000 and \$431,628,000, respectively.

**Capital Lease** The Company completed the installation of an Automated Meter Reading (AMR) system at Missouri Gas Energy 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 June 30, 1999, the capital lease obligation outstanding was \$26,894,000 with a fixed rate of 5.79%. During 1999, the Company recorded an increase in plant and long-term debt of \$6,824,000. 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 two revolving credit facilities (Revolving Credit Facilities) underwritten by a syndicate of banks. Of the Revolving Credit Facilities, \$40,000,000 is available under a short-term facility which expires June 29, 2000, while \$60,000,000 is available under a long-term facility which expires June 30, 2002. 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. The Revolving Credit Facility is subject to a commitment fee based on the rating of the Senior Notes. As of June 30, 1999, 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 5.6% for the year ended June 30, 1999 and 6.1% for the year ended June 30, 1998. A \$21,000,000 and \$1,600,000 balance was outstanding under the facilities at June 30, 1999 and 1998, respectively. A balance of \$17,900,000 was outstanding under the facilities at July 31, 1999.

**XII EMPLOYEE BENEFITS**

**Pension and Other Post-retirement Benefits** The Company adopted in 1999, *Employers Disclosures About Pensions and Other Post-Retirement Benefits*, a FASB standard which changed the Company's reporting requirements for its pension and post-retirement benefit plans.

The Company maintains two trustee non-contributory defined benefit retirement plans (Plans) which cover substantially all employees. 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. The Company also has a supplemental non-contributory retirement plan for certain executive employees and other post-retirement benefit plans for its employees. Post-retirement medical and other benefit liabilities are accrued on an actuarial basis during the years an employee provides services. The following table represents a reconciliation of the plans at June 30, 1999 and 1998.

	1999	1998
<b>Change in Benefit Obligation</b>		
Benefit obligation at beginning of year	\$ 188,038	\$ 172,225
Service cost	3,364	3,302
Interest cost	13,829	13,658
Benefits paid	(13,563)	(12,382)
Actuarial loss	7,968	11,235
Plan amendments	7,027	-
Curtailement	(2,202)	-
<b>Benefit obligation at end of year</b>	<b>\$ 204,461</b>	<b>\$ 188,038</b>
<b>Change in Plan Assets</b>		
Fair value of plan assets at beginning of year	\$ 166,353	\$ 132,599
Return on plan assets	3,420	40,262
Employer contributions	6,411	5,874
Benefits paid	(13,563)	(12,382)
<b>Fair value of plan assets at end of year</b>	<b>\$ 162,621</b>	<b>\$ 166,353</b>

	1999	1998
<b>Funded Status</b>		
Funded status at end of year	\$ (41,839)	\$ (21,685)
Unrecognized transition obligation	2,764	2,891
Unrecognized net actuarial (gain)	(7,404)	(25,977)
Unrecognized prior service cost	9,913	3,455
<b>Accrued benefit cost</b>	<b>\$ (36,566)</b>	<b>\$ (41,316)</b>
<b>Amounts Recognized in the Consolidated Balance Sheet</b>		
Prepaid benefit cost	\$ 4,880	\$ 2,339
Accrued benefit liability	(52,618)	(45,806)
Intangible asset	10,501	2,151
Accumulated other comprehensive income	671	-
<b>Net amount recognized</b>	<b>\$ (36,566)</b>	<b>\$ (41,316)</b>

The projected benefit obligation, accumulated benefit obligation and fair value of plan assets for the plans with accumulated benefit obligations in excess of plan assets as of June 30, 1999 were \$58,985,000; \$58,985,000; and \$42,181,000, respectively, and for those same plans were \$46,158,000; \$37,783,000; and \$41,907,000, respectively as of June 30, 1998.

The weighted-average assumptions used for the year ended June 30, 1999 and 1998 were:

	1999	1998
<b>Discount rate</b>		
Beginning of year	7.00%	7.75%
End of year	7.00%	7.25%
Expected return on assets - tax exempt accounts	8.00%	8.00%
Expected return on assets - taxable accounts	5.25%	8.00%
Rate of compensation increase (average)	5.62%	5.62%
Health care cost trend rate	7.25%	7.50%

Net periodic benefit cost for the year ended June 30, 1999, 1998 and 1997 includes the following components:

	1999	1998	1997
Service cost	\$ 3,364	\$ 3,302	\$ 3,258
Interest cost	13,829	13,658	13,240
Expected return on plan assets	(13,006)	(11,737)	(10,335)
Amortization of transition amount	127	127	127
Amortization of prior service cost	438	340	291
Recognized actuarial (gain)	(3,319)	(4,828)	(1,980)
Curtailement	131	-	-
<b>Net periodic pension cost</b>	<b>\$ 1,564</b>	<b>\$ 862</b>	<b>\$ 4,601</b>

The assumed health care cost trend rate used in measuring the accumulated post-retirement benefit obligation was 7.25% during 1999. This rate was assumed to decrease gradually each year to a rate of 6.0% for 2004 and remain at that level thereafter.

Amortization of unrecognized gains and losses for Missouri Gas Energy plans were determined using a rolling five year average gain or loss position with a five year amortization period, pursuant to a stipulation agreement with the MPSC.

Effect of health care trend rate changes on health care plans:

	ONE PERCENTAGE POINT INCREASE IN HEALTH CARE TREND RATE	ONE PERCENTAGE POINT DECREASE IN HEALTH CARE TREND RATE
Effect on total service and interest cost components	\$ 29,000	\$ (28,000)
Effect on post-retirement benefit obligation	322,000	(319,000)

The Company's two defined benefit retirement Plans cover (i) those Company employees who are not employed by Missouri Gas Energy and (ii) those employees who are employed by Missouri Gas Energy. On December 31, 1998, the Plans, exclusive of Missouri Gas Energy's union employees were converted from the traditional defined benefit Plans with benefits based on years of service and final average compensation to cash balance defined benefit plans in which an account is maintained for each employee. The initial value of the account was determined as the actuarial present value (as defined in the Plans) of the benefit accrued at transition (December 31, 1998) under the pre-existing traditional defined benefit plan. Future contribution credits to the accounts are based on a percentage of future compensation, which varies by individual. Interest credits to the accounts are based on 30-year Treasury bond yields.

**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. Effective July 1, 1998, Company contributions for Missouri Gas Energy non-union employees were revised to coincide with that of non-Missouri Gas Energy participants as described above. 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 1999, 1998 and 1997, were \$1,717,000, \$1,656,000 and \$1,476,000, respectively.

Effective January 1, 1999 the Company amended its defined contribution plan to provide contributions of certain employees who were employed as of December 31, 1998. These contributions were designed to replace certain benefits previously provided under defined benefit plans. Employer contributions to these separate accounts, referred to as Retirement Power Accounts, within the defined contribution plan were determined based on the employee's age plus years of service plus accumulated sick leave as of December 31, 1998. The contribution amounts are determined as a percentage of compensation and range from 3.5% to 8.5%. Company contributions to Retirement Power Accounts during 1999 were \$1,118,000.

**Post-employment Benefits** Certain post-employment 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 employees' 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 both June 30, 1999 and 1998, the Company has recorded a regulatory asset and a related liability of \$1,343,000.

**Common stock held in trust** From time to time, the Company repurchases outstanding shares of common stock of Southern Union to fund certain Company employee stock-based compensation plans. At June 30, 1999, 268,513 shares of common stock were held by various rabbi trusts for certain of the Company's benefit plans.

XIII TAXES ON INCOME

YEAR ENDED JUNE 30	1999	1998	1997
Current:			
Federal	\$ (516)	\$ 1,381	\$ 4,437
State	(242)	240	596
	(758)	1,621	5,033
Deferred:			
Federal	7,024	5,984	6,690
State	843	379	650
	7,867	6,363	7,340
Total provision	\$ 7,109	\$ 7,984	\$ 12,373

Deferred credits and other liabilities also include \$560,000 and \$593,000 of unamortized deferred investment tax credit as of June 30, 1999 and 1998, respectively.

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

JUNE 30	1999	1998
Deferred tax assets:		
Estimated alternative minimum tax credit	\$ 9,557	\$ 10,554
Insurance accruals	2,297	3,074
Bad debt reserves	2,715	-
Post-retirement benefits	1,466	1,079
Minimum pension liability	234	-
Other	3,020	1,230
Total deferred tax assets	19,289	15,937
Deferred tax liabilities:		
Property, plant and equipment	(74,909)	(65,564)
Unamortized debt expense	(5,049)	(5,270)
Other	(6,731)	(5,330)
Total deferred tax liabilities	(86,689)	(76,164)
Net deferred tax liability	(67,400)	(60,227)
Less current tax assets	2,838	2,378
Accumulated deferred income taxes	\$ (70,238)	\$ (62,605)

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.

YEAR ENDED JUNE 30	1999	1998	1997
Computed statutory tax expense at 35%	\$ 6,144	\$ 7,075	\$ 10,992
Changes in taxes resulting from:			
State income taxes, net of federal income tax benefit	348	402	811
Amortization of acquisition adjustment	830	723	724
Other	(213)	(216)	(154)
Actual tax expense	\$ 7,109	\$ 7,984	\$ 12,373

#### XIV UTILITY REGULATION AND RATES

On August 21, 1998, Missouri Gas Energy was notified by the MPSC of its decision to grant a \$13,300,000 annual increase to revenue effective on September 2, 1998, which is primarily earned volumetrically. 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. The Company recorded this charge to earnings in its fiscal year ended June 30, 1998. On December 8, 1998, the MPSC denied rehearing requests made by all parties other than Missouri Gas Energy and granted a portion of Missouri Gas Energy's rehearing request. The MPSC will conduct further proceedings to take additional evidence on those matters for which it granted Missouri Gas Energy a rehearing. If the MPSC adopts Missouri Gas Energy's positions on rehearing, then Missouri Gas Energy would be authorized an additional \$2,200,000 of base revenues increasing 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 Missouri Gas Energy's authorized base revenue increase on judicial review, Missouri Gas Energy expects such arguments to be unsuccessful.

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. On May 21, 1998, Southern Union Gas filed with the Railroad Commission of Texas (RRC) 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. On December 21, 1998, the RRC issued its order implementing an \$884,000 one-time cost of gas refund and a \$99,000 base rate reduction. The cost of gas refund was completed in February 1999.

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 years ended June 30, 1999, 1998 and 1997, the incentive plan achieved a reduction of overall gas costs of \$6,900,000, \$9,200,000 and \$10,200,000, respectively, resulting in savings to Missouri customers of \$4,000,000, \$5,100,000 and \$5,600,000, respectively. The Company recorded revenues of \$2,900,000, \$4,100,000 and \$4,600,000 in 1999, 1998 and 1997, respectively, under this plan. Missouri Gas Energy is currently working with the MPSC to develop an alternate plan due to the July 1, 1999 expiration of the experimental gas supply incentive plan, however, there can be no assurance that this or any similar plan will be approved by the MPSC for Missouri Gas Energy.

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 \$669,000 at June 30, 1999. 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, 1999 and 1998.

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.

#### 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: 2000 – \$6,062,000; 2001 – \$4,973,000; 2002 – \$4,039,000; 2003 – \$2,236,000; 2004 – \$1,225,000 and thereafter \$11,162,000. Rental expense was \$7,732,000, \$6,054,000 and \$6,797,000 for the years ended June 30, 1999, 1998 and 1997, respectively.

#### XVI COMMITMENTS AND CONTINGENCIES

**Environmental** 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 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. 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 a letter dated May 10, 1999, the Missouri Department of Natural Resources (MDNR) sent notice of a planned Site Inspection/Removal Site Evaluation of the Kansas City Coal Gas Former Manufactured Gas Plant (FMGP) site. This site (comprised of two FMGP operations previously owned by two separate companies) is located at East 1st Street and Campbell in Kansas City, Missouri and is owned by Missouri Gas Energy. A 1988 investigation of the site performed by an Environmental Protection Agency (EPA) contractor determined that further remedial assessment was not required under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), as amended by the Superfund Amendments and Reauthorization Act of 1986. The MDNR has stated that the reassessment of the Kansas City Coal Gas site is part of a statewide effort to identify, evaluate, and prioritize the potential hazards posed by all of Missouri's FMGP sites. During July 1999, the Company sent applications to MDNR submitting the two sites to the agency's Voluntary Cleanup Program. In two letters, both dated August 2, 1999, the MDNR accepted the sites into the Voluntary Cleanup Program. The Company subsequently submitted two work plans for the environmental assessment of the sites to MDNR.

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. 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.

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.

**Regulatory** On August 18, 1998, the Missouri State 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 Missouri Gas Energy 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 sought a transfer of the case to the Missouri Supreme Court which was denied on November 24, 1998.

The continuation of the Missouri Safety Program will result in significant levels of future capital expenditures. The Company estimates incurring capital expenditures of \$14,372,000 in fiscal 2000 related to this program.

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 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 that the outcome of this matter will not have a material adverse impact on the Company's results of operations, financial position or cash flows. Furthermore, the Company has not determined what impact, if any, this jury decision may have on other city franchises in Texas.

**Southwest Gas Litigation** On February 1, 1999, Southern Union submitted a proposal to the Board of Directors of Southwest Gas Corporation (Southwest) to acquire all of Southwest's outstanding common stock for \$32.00 per share. Southwest then had a pending merger agreement with ONEOK, Inc. (ONEOK) at \$28.50 per share. On February 22, 1999, Southern Union and Southwest both publicly announced Southern Union's proposal, after the Southwest Board of Directors determined that Southern Union's proposal was a Superior Proposal (as defined in the Southwest merger agreement with ONEOK). At that time Southern Union entered into a Confidentiality and Standstill Agreement with Southwest at Southwest's insistence. On April 25, 1999, Southwest's 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 shareholders with a 6% annual rate of return on its \$33.50 offer, commencing February 15, 2000, until closing. According to public statements by Southwest, Southern Union's revised proposal also has been rejected by Southwest's Board of Directors.

There are four lawsuits pending that relate to activities surrounding Southern Union's efforts to acquire Southwest. In addition, there is before the U.S. Court of Appeals for the Tenth Circuit, an appeal by Southern Union of a preliminary injunction entered by the U.S. District Court for the Northern District of Oklahoma. Southern Union intends to vigorously pursue its claims against Southwest, ONEOK, and certain individual defendants, and vigorously defend itself against the claims by Southwest and ONEOK.

**California Action** Pursuant to notice given by Southern Union to Southwest on April 28, 1999, the Superior Court of California for San Diego County on May 4, 1999, granted a motion by Southern Union and SU Acquisition Corporation, a Southern Union subsidiary, for leave to file a complaint in intervention in a pending Southwest shareholders' derivative suit styled, *Klein v. Southwest Gas Corp.* Southern Union's complaint sought partial rescission of the Confidentiality and Standstill Agreement, a declaration of the rights of the parties under the Confidentiality and Standstill Agreement, and a request for a preliminary injunction barring Southwest from submitting proxies to its shareholders seeking their approval of a merger with ONEOK until the merits of Southern Union's claims could be adjudicated. On May 17, 1999, Southwest removed the *Klein* case to the United States District Court for the

Southern District of California. The shareholder plaintiffs and Southern Union then moved to remand the case back to the California Superior Court. According to the definitive Southwest proxy statement with respect to the ONEOK merger (released on June 29, 1999) on June 9, 1999, Southwest signed a Memorandum of Understanding (MOU) with the shareholder plaintiffs' counsel to settle this action as to all plaintiffs, except Southern Union. The MOU sets forth the parties' agreement in principle settling all of the shareholders' claims arising out of the actions of Southwest and its directors relating to the ONEOK merger, and will be incorporated into a final Stipulation Settlement. The MOU is not an admission of any of the plaintiffs' allegations. Southwest and its directors have denied and continue to deny that they have committed or attempted to commit any wrongdoing or breached any duty owed to Southwest or its shareholders. The MOU is subject to several conditions, including the consummation of the ONEOK merger and the entry of a final judgment of dismissal with prejudice by the U. S. District Court that is binding on all shareholders from December 14, 1998 through the date that the shareholders approve the ONEOK merger. By Order dated August 3, 1999, the federal district court granted Southern Union's motion to remand the case to California Superior Court. On August 5, 1999, Southern Union moved the California Superior Court to sever its claims against Southwest and also sought a temporary restraining order barring Southwest from participating in any further proceedings before the California Public Service Commission and from taking any other action to consummate its pending merger with ONEOK until the court determined the merits of Southern Union's claims. Following a hearing on August 5, the California Superior Court judge denied Southern Union's request for a temporary restraining order in a ruling announced from the bench. Also on August 5, Southwest moved the court to stay all proceedings in the case. On August 18, the court granted Southern Union's motion to sever. On August 24, 1999, the court ruled on Southwest's motion and stayed action in the state court proceeding pending resolution of the federal actions filed by the parties.

**Nevada Action** On April 20, 1999, Southwest filed an action against Southern Union Company in the United States District Court for the District of Nevada. The complaint alleged breach of the Confidentiality and Standstill Agreement between Southern Union and Southwest, misappropriation of original trade secrets in violation of California statutes, intentional interference with the ONEOK merger agreement, intentional interference with prospective advantage, breach of a common-law duty of good faith and fair dealing, and unfair business practices in violation of California statutes. On May 6, 1999, Southwest filed an amended complaint that added a claim for breach of the Securities Exchange Act of 1934 to the claims in the original complaint. Southwest seeks declaratory and injunctive relief together with money damages "in excess of \$75,000.00." Southern Union has answered the complaint, denying liability under all counts. Southern Union has filed a counterclaim alleging breach of contract, breach of duty of good faith and fair dealing, mistake of fact and fraudulent inducement with respect to the Confidentiality and Standstill Agreement. The counterclaim seeks partial rescission of the Confidentiality and Standstill Agreement, or a declaration that Southern Union is entitled to take all actions legal and necessary to directly solicit Southwest's shareholders to oppose Southwest's agreement to merge with ONEOK or any other party, and to support Southern Union's efforts to merge with or acquire Southwest, or acquire all or some of Southwest's outstanding common shares. Southwest has filed a motion to transfer the case to the United States District Court for the Northern District of Oklahoma, which Southern Union has opposed. That motion is currently awaiting decision by the court. On June 30, 1999, Southern Union filed a motion for partial judgment on the pleadings with respect to Southwest's state law claims. The motion is based on Nevada Revised Statute 41,650 which, in part, provides for immunity from civil liability for "good faith communications in connection with the right to petition." That motion also is pending currently.

**Oklahoma Action** On May 5, 1999, ONEOK filed an action against Southern Union in the United States District Court for the Northern District of Oklahoma, asserting third-party beneficiary status under the Confidentiality and Standstill Agreement between Southern Union and Southwest, and alleging a claim for breach of that Agreement as well as a claim for intentional interference with the ONEOK-Southwest merger agreement. That same day, ONEOK moved for a temporary restraining order against Southern Union to bar Southern Union from making any attempt to solicit proxies from or influence the shareholders of Southwest with respect to Southern Union's offer to purchase Southwest, from taking any actions in the regulatory proceedings that concern the proposed merger of ONEOK and Southwest, from taking any actions in the *Klein v. Southwest Gas Corp.* case and from taking any actions that seek to control or influence the shareholders, management, directors or policies of Southwest, either alone or in concert with others. On May 10, 1999 the Court entered a temporary restraining order that barred Southern Union from breaching the standstill provisions of the Confidentiality and Standstill Agreement. By agreement of the parties, the temporary restraining order was converted to a preliminary injunction on May 17, 1999. Southern Union has filed a motion to dismiss the ONEOK

complaint in lieu of an answer denying ONEOK's allegations. On July 19, 1999, Southern Union moved the Oklahoma district court to vacate or suspend its preliminary injunction on the basis of newly-discovered evidence (which also is the basis for Southern Union's Arizona action described below) that showed that ONEOK came to court with "unclean hands" and that Southwest had fraudulently induced Southern Union to enter into the Confidentiality and Standstill Agreement that was the basis for the court's injunction. This motion was denied on jurisdictional grounds by order dated July 23, 1999. On August 3, 1999, ONEOK moved the court to hold Southern Union in contempt for having filed the Arizona action assertedly in violation of the Oklahoma court's May 17, 1999 preliminary injunction. At a status hearing on August 11, 1999, the judge said that the May 17, 1999 preliminary injunction did not bar Southern Union from filing the Arizona action. While he did not expressly deny ONEOK's motion, the judge orally directed ONEOK to amend its motion if it wished the court to give it any further consideration. ONEOK subsequently moved for an emergency hearing (to show cause) regarding the preliminary injunction. The court heard arguments on that motion on August 30, 1999. The judge has taken the matter under advisement and has requested that additional information be provided to the court.

**Appeal of Oklahoma Action** On May 17, 1999, Southern Union noticed its appeal of the Oklahoma district court's preliminary injunction in the United States Court of Appeals for the Tenth Circuit. At the same time Southern Union sought from the court of appeals a stay of the district court's injunction pending a decision on the merits of the appeal. On June 1, 1999, the Tenth Circuit issued a "temporary stay" of the district court's order to permit Southern Union to file a motion in the *Klein* case to Southwest Gas' motion to transfer it to the Northern District of Oklahoma. On June 3, 1999 Southern Union supplemented its request for a stay of the district court's order to permit Southern Union to resume its participation in the various state public utility commission proceedings considering the proposed ONEOK-Southwest Gas merger. On June 10, 1999, the Tenth Circuit issued an order denying Southern Union's request for the further stay and on August 24, 1999 the Tenth Circuit vacated its temporary stay of June 3, 1999 as moot and denied Southern Union's request for any further stay of the district court order pending appeal. Briefing for the appeal has been completed.

**Arizona Action** On July 19, 1999, Southern Union filed an action in the United States Court for the District of Arizona against Southwest, ONEOK, Michael O. Maffie (Southwest's President), Thomas Y. Hartley (Southwest's Chairman), Eugene N. Dubay (President of Kansas Gas Service, a division of ONEOK), James M. Irvin (an Arizona Corporation Commissioner), Jack D. Rose (former Executive Director of the Arizona Corporation Commission), Thomas R. Sheets (Southwest's General Counsel), and John A. Gaberino, Jr. (ONEOK's General Counsel). The suit alleges racketeering under federal and state law, fraud in the inducement, breach of contract, Securities Exchange Act violations, breach of the covenant of good faith and fair dealing, rescission, intentional interference with business relationship, tortious interference with contractual relations and civil conspiracy. Southern Union seeks damages of \$750 million on each of the two racketeering counts, to be trebled; \$750 million on six other counts; punitive damages on four counts; and rescission of its Standstill Agreement with Southwest. On August 2, 1999, Southern Union moved for a temporary restraining order barring both Southwest and ONEOK from participating in any further regulatory proceedings before the Arizona Corporation Commission. Southern Union also asked the Arizona court to bar Arizona Corporation Commissioner James Irvin "from any involvement in ongoing procedures concerning regulatory approval by the ACC." On August 5, 1999, the court held a hearing on the motion and, at the conclusion of the hearing, orally denied Southern Union's request.

The Company believes that the results of the above-noted Southwest Gas Litigation will not have a materially adverse effect on the Company's financial condition.

**Other** 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.

**Commitments** The Company is committed under various agreements to purchase certain quantities of gas in the future. At June 30, 1999, the Company has purchase commitments for certain quantities of gas at variable, market-based prices that have an annual value of \$94,275,000. 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 December 1998, the Company agreed to five-year contracts with each bargaining-unit representing Missouri employees, which were effective in May 1999. Of the Company's employees represented by unions, 95% are employed by Missouri Gas Energy.

The Company had standby letters of credit outstanding of \$1,622,000 and \$2,947,000 at June 30, 1999 and 1998, respectively, which guarantee payment of various insurance premiums and state taxes.

**XVII QUARTERLY OPERATIONS (UNAUDITED)**

YEAR ENDED JUNE 30, 1999	QUARTER ENDED				TOTAL
	SEPTEMBER 30	DECEMBER 31	MARCH 31	JUNE 30	
Total operating revenues	\$ 77,455	\$ 174,224	\$ 251,863	\$ 101,689	\$ 605,231
Operating margin	42,781	70,286	98,106	51,757	262,930
Net operating revenues (loss)	(627)	19,986	40,647	4,841	64,847
Net earnings (loss) available for common stock	(7,048)	5,374	17,624	(5,505)	10,445
Earnings (loss) per share – diluted <sup>(1)</sup>	(.23)	.16	.54	(.18)	.32

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 <sup>(2)</sup>	(4,909)	9,738	16,249	(8,849)	12,229
Earnings (loss) per share – diluted <sup>(1)</sup>	(.17)	.31	.50	(.28)	.39

<sup>(1)</sup> 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.

<sup>(2)</sup> 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.

**FINANCIAL STATEMENT RESPONSIBILITY**

The information appearing in the 1999 Annual Report of Southern Union Company was prepared by management in conformity with generally accepted accounting principles and reflects the best estimates and judgement of management.

The Company's system of internal controls is designed to provide reasonable assurance that assets are safeguarded and that transactions are executed in accordance with management's authorizations and recorded to permit preparation of financial statements that present fairly the financial position and operating results of the Company. The Company's internal auditors evaluate and test the system of internal controls. The Company's Vice President-Audit reports directly to the Audit Committee of the Board of Directors, which is composed solely of directors who are outside of the Company. The Audit Committee meets periodically with management, the Vice President-Audit and PricewaterhouseCoopers LLP to review and discuss internal accounting controls, audit results, accounting principles and practices and financial reporting matters.

**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, 1999 and 1998, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 1999, 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*

PricewaterhouseCoopers LLP  
 Austin, Texas  
 August 12, 1999, except  
 for Note XVI,  
 as to which the date  
 is September 3, 1999

**CORPORATE INFORMATION**

**FORM 10-K**

The Company is required to file an annual report on Form 10-K with the Securities and Exchange Commission, which includes additional information concerning the Company and its operations. A copy of this report will be forwarded upon written request to Executive Offices, Southern Union Company, 504 Lavaca Street, Suite 800, Austin Texas 78701.

The Form 10-K also is available for online viewing at Southern Union's web site: [www.southernunionco.com](http://www.southernunionco.com).

**STOCK DIVIDEND SALE PLAN**

Southern Union's Stock Dividend Sale Plan provides common stockholders a convenient, commission-free method of selling regular stock dividends and receiving the cash proceeds. A prospectus and enrollment card may be obtained by contacting the Plan Administrator, The First National Bank of Boston, at (800) 736-3001.

**DIRECT COMMON STOCK PURCHASE PLAN**

Southern Union's Direct Common Stock Purchase Plan offers investors an economical method of investing in the Company's Common Stock. A prospectus and enrollment form can be obtained by contacting the Plan Administrator, The First National Bank of Boston, at (800) 793-8938.

**INVESTOR RELATIONS**

George Yankowski  
 Treasurer and Director of Investor Relations  
 Southern Union Company  
 504 Lavaca, Suite 800  
 Austin, Texas 78701  
 (512) 370-8305

**TRANSFER AGENT**

BankBoston, N.A.  
 c/o EquiServe, L.P.  
 Post Office Box 8040  
 Boston, Massachusetts 02266-8040  
 (800) 736-3001

**COMMON STOCK**

Southern Union's common stock is traded on the New York Stock Exchange under the symbol "SUG." As of August 31, 1999, there were 31,235,009 shares of Southern Union common stock outstanding, owned by 1,142 holders of record. See Stockholders' Equity in the Notes to Consolidated Financial Statements for an explanation of the dividend policy and restrictions on dividends.

COMMON STOCK DATA BY QUARTERS	STOCK PRICE RANGE	
	HIGH	LOW
1999 by Fiscal Quarter:		
Fourth	\$ 21.79	\$ 17.62
Third	23.21	16.55
Second	23.33	17.63
First	20.30	14.17
1998 by Fiscal Quarter:		
Fourth	\$ 19.73	\$ 14.43
Third	14.97	13.84
Second	15.61	13.10
First	14.11	12.53

**GENERAL COUNSEL**

Fleischman and Walsh, L.L.P.  
 1400 Sixteenth Street, N.W.  
 Washington, D.C. 20036

**AUDITORS**

PricewaterhouseCoopers LLP  
 600 Congress, Suite 1800  
 Austin, Texas 78701

BOARD OF DIRECTORS AND OFFICERS

DIRECTORS

George L. Lindemann  
Chairman of the Board and  
Chairman of the Executive Committee

John E. Brennan  
Vice Chairman of the Board and  
Member of the Executive Committee

Frank W. Denius  
Chairman Emeritus and  
Chairman of the Audit Committee

Aaron I. Fleischman

Kurt A. Gitter, M.D.  
Member of the Audit Committee

Peter H. Kelley  
Member of the Executive Committee

Adam M. Lindemann

Roger J. Pearson

George Rountree, III

Dan K. Wassong

OFFICERS

George L. Lindemann  
Chairman of the Board and  
Chief Executive Officer

John E. Brennan  
Vice Chairman of the Board and  
Assistant Secretary

Peter H. Kelley  
President and  
Chief Operating Officer

Ronald J. Endres  
Executive Vice President and  
Chief Financial Officer

Steven W. Cattron  
President - Missouri Gas Energy

David W. Stevens  
President - Southern Union Gas Company

Nancy M. Capezzuti  
Senior Vice President - Human Resources

David J. Kvapil  
Senior Vice President and  
Corporate Controller

Dennis K. Morgan  
Senior Vice President - Legal and Secretary