State of Rhode Island and Providence Plantations

DEPARTMENT OF ATTORNEY GENERAL
150 South Main Street • Providence, RI 02903
(401) 274-4400
TDD (401) 453-0410

Patrick C. Lynch, Attorney General

July 11, 2006

VIA ELECTRONIC FILING AND HAND DELIVERY

Luly Massaro, Clerk
Public Utilities Commission
89 Jefferson Blvd.
Warwick, RI 02888

Re: Joint Petition of Narragansett Electric Company and Southern Union Company for Approval of Purchase and Sale of Assets; RIDPUC Docket No. D-06-13

Dear Ms. Massaro:

Enclosed for filing in connection with the above-referenced matter is an original and nine (9) copies of the Post Hearing Brief of the Rhode Island Department of Attorney General.

Thank you for your attention to this matter.

Very truly yours,

Paul Roberti
Assistant Attorney General
Chief, Regulatory Unit

Enclosures
cc: Service List

STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS

DIVISION OF PUBLIC UTILITIES AND CARRIERS

IN RE:	JOINT PETITION OF THE NARRAGANSETT ELECTRIC COMPANY AND SOUTHERN UNION COMPANY FOR APPROVAL OF PURCHASE AND SALE OF ASSETS	Docket D-06-13

POST HEARING BRIEF OF THE RHODE ISLAND DEPARTMENT OF ATTORNEY GENERAL

I. BACKGROUND

In the Joint Application filed in this proceeding before the Division of Public Utilities and Carriers ("Division"), Southern Union Company ("Southern") seeks Division approval of the sale of Southern's natural gas distribution business in Rhode Island. This proposed action is just one step in Southern's overall business plan to convert itself from a gas distribution business into a gas pipeline and gathering business, largely substituting state with federal economic regulation and transforming its corporate structure. At the same time that Southern seeks to depart the State of Rhode Island, enriched by the proceeds of the sale of its Rhode Island assets to The Narrangansett Electric Company, d/b/a National Grid ("National Grid"), it is vigorously contesting its legal responsibility for the very large legacy environmental remediation costs visited on Rhode Island citizens of Southern's natural gas distribution operations.

The Department of Attorney General ("RIAG" or "Attorney General") submits that these parallel actions by Southern squarely conflict with the public interest – the

governing standard for the Division's decision in this proceeding. In any approval of the Joint Application, the Division must, at a minimum, attach appropriate conditions, discussed in greater detail later in this brief, which address and seek to mitigate the harm to the public interest posed by Southern's proposed actions.

As noted, Southern is currently engaged in a massive conversion of its business -- restructuring its corporate enterprise to sell off its natural gas distribution assets and focus on wholesale energy markets, including the gathering, processing and transportation of natural gas. To that end, Southern has already sold its historic, original and base franchise of natural gas operations in South Texas. It now proposes selling its Rhode Island gas operations ("NEG-RI") and, at the same time, is in the process of selling its Pennsylvania gas operations ("PG Energy"), and has expressed an interest selling its Missouri distribution operations ("Missouri Gas Energy"). The company also seeks to sell or transfer the assets of its Massachusetts gas distribution operations to a directly or indirectly owned subsidiary.

All of the natural gas distribution businesses and assets sold or proposed for sale have been, or are, owned directly by Southern, the parent corporation. All of the new businesses acquired by Southern are held through first, second or third tier limited liability entities. Initially, proceeds from the sale of NEG-RI and PG Energy will be used to pay off, in part, a $1.6 billion bridge loan that the company took out to purchase Sid Richardson Energy Services, a gas pipeline and gathering enterprise located in Texas and New Mexico. The Sid Richardson sale is now complete, and Sid Richardson's family of entities has been renamed "Southern Union Gas Services."

In 2002, sub-surface excavations were conducted in the Bay Street Area, Tiverton, Rhode Island, in connection with the construction of the Mount Hope Interceptor Sewer Project. Soil excavated during the performance of this work, and stockpiled at two locations in the Bay Street Area, was observed to have a "blue color" indicative of coal gasification waste material (*i.e.*, cyanide). Rhode Island Department of Environmental Management ("RIDEM"), Notice of Intent to Enforce, Dated November 23, 2005 (the "RIDEM NOIE"), Para. 3. Extensive petroleum-based contamination was discovered and a petroleum sheen was observed in groundwater seeping into the excavation. *See*, EA Engineering, Science and Technology, Inc., Site Investigation Report Addendum (2) (dated January, 2004) (the "EA Report"), p. 4 of 12.

In work conducted by EA and described in the EA Report, EA subsequently performed soil borings at various locations in the Bay Street area which discovered semivolatile organic compounds (SVOCs), particularly polycyclic aromatic hydrocarbons (PAHs), and cyanide at levels exceeding both the RIDEM Residential and Industrial/Commercial Direct Exposure Criteria (RDEC and I/CDEC). Additional investigations to try to establish boundaries to the area of contamination were conducted by EA and uncovered additional areas of soil contamination, including highly contaminated wood mulch. Ultimately, the area impacted by the contamination includes approximately 100 residential parcels and several commercial properties in the northeastern section of Tiverton, along and proximate to Bay Street and several streets intersecting with Bay Street. RIDEM NOIE, Paras. 1-8.

In seeking to establish the source of the contamination in the Bay Street Area, EA stated as follows in the EA Report:

> [A]necdotal evidence has been found to link this contamination to historic dumping of manufactured gas plant waste material by the former Fall River Gas Company. Chemical profiles of the contaminated soil and organic material are consistent with this suspected source.

EA Report at p. 4 of 12. The RIDEM NOIE also states as follows:

> 7. ....a former employee of Fall River Gas Company observed that "blue soil" was in the fill material (1-3 feet in depth) along State and Bay Street and that the disposal of this fill may have occurred over a ten-year period during the 1960's and early 1970's.
>
> 8. The suspected source of the contaminated fill material was stated to be the former Fall River Gas Company.

Separately, Fall River Gas Company ("FRG") has reported the operation of two former manufactured gas plants ("MGP"), one located at Bay Street and Charles Street in Fall River and a second at Anawan and Pond Street in Fall River.[1] Under the rules for determining legal liability for environmental contamination, responsible parties can be held liable on a joint and several basis for the cost of clean-up (*i.e.*, if legal responsibility for some portion of the contamination is established with respect to a party, then that party may initially bear the full quantum of liability, with recourse to an action in contribution against other responsible parties to reallocate the liability). Accordingly, FRG's responsibility for clean-up of the contamination, as asserted by RIDEM, is joint and several. The cost estimate for clean-up of the Bay Street Area environmental contamination, established for purposes of this proceeding, ranges between $30 million and $55 million. See Joint Exhibit 1 between National Grid, RIDEM, Tiverton and the Attorney General.

[1] See Agreement of Merger between Southern Union Company and Fall River Gas Company, dated as of Oct. 4, 1999, Schedule 5.19, FAL Disclosure Schedule.

Southern acquired FRG in a merger in 2000 and operated FRG thereafter as a division of Southern. Insofar as disclosed by Southern in this proceeding, Southern intends, in the future, to transfer its Massachusetts natural gas distribution operating assets into a corporate, limited liability subsidiary.

II. STANDARD OF REVIEW

G.L. § 39-3-25 provides as follows in connection with proceedings for approval of transactions between utilities:

> If . . . the division is satisfied that the prayer of the petition should be granted, that the facilities for furnishing service to the public will not thereby be diminished, and that the purchase, sale, or lease and the terms thereof are *consistent with the public interest*, it shall make such order in the premises as it may deem proper and the circumstances may require.

(Emphasis added).

Whether a particular matter is determined to be "consistent with the public interest" is made on a case-by-case basis. Individual factors such as ratepayer benefit, ratepayer burden, quality of service, alternative transactions, *etc.* are by no means exhaustive of the criteria that must be analyzed to determine whether a particular transaction accords with the public interest. Massachusetts Department of Public Utilities Guidelines and Standards for Acquisitions and Mergers, 155 P.U.R. 4th 153 (August 3, 1994)[2]. See also G.L. § 39-1-1 (the businesses of distributing electrical energy, producing and transporting manufactured and natural gas, ... are affected with a "public interest" which

[2] The Division has factored into its approval of a transaction between utilities the following items: whether ratepayers actually benefit from the transaction, whether ratepayers are harmed by the transaction, the impact of the transaction upon quality of service, and the impact of the transaction upon billing. In Re: Petitions of Valley Gas Company and Petition of Providence Energy Corporation, Docket Nos. D-00-02 and D-00-03, Order 16338 (July 24, 2000).

includes due regard for the preservation, enhancement of the environment and the protection and promotion of the welfare of the people).

III. DISCUSSION[3]

The Attorney General recommends that the Division approve the pending transaction subject to and on condition that the Division impose as conditions to the approval, requirements binding on Southern consistent with those discussed in the Testimony of Philip. L. Sussler at Pages 14-17 (the "Conditions"), namely: (i) Consent to Jurisdiction, (ii) Waiver of Defense to Liability, and (iii) Financial Assurance and Southern Guarantee. Since the cost to clean up the Bay Street neighborhood will range between the $30 million and $55 million established for purposes of this proceeding in Joint Exhibit 1 of National Grid, DEM, Tiverton and the Attorney General, the Division should require the upper end of this range ($55 million) to be held in escrow pending the conclusion of the inevitable litigation between Southern and the State of Rhode Island.

As will be seen below, if the pending transaction is approved without the Conditions, the State of Rhode Island will take on substantially greater material risk that Southern will engage in a strategy of prolonged litigation the sole aim of which will be to compel the State to pay for most if not all of the cost of the Tiverton site remediation. ***The Division (and the Division alone) will bear the responsibility for this outcome.***

[3] The Attorney General reserves and reasserts all of his rights in connection with respect to each and every data request that has been the subject of his various motions to compel and which the Division has denied. The Attorney General, further, reserves and reasserts all of his rights in connection with the unduly expedited procedural schedule, which the Division has refused to extend in order to permit the Attorney General sufficient time to conduct the appropriate degree of due diligence in this matter. In the Attorney General's opinion, the agency process effected in connection with respect the pending docket constitutes an abuse of discretion, is clearly erroneous, is arbitrary and capricious, is in excess of the statutory authority of the Division, is made upon unlawful procedure, and is in violation of the public's right to due process of the law.

Given the increased substantial and material risk to the State in these circumstances, approval of the pending transaction without the attached conditions is not consistent with the public interest, constitutes a gross abuse of discretion, is clearly erroneous, and is arbitrary and capricious.

A. SOUTHERN'S CORPORATE STRUCTURE SHIELDS ALL OF ITS ASSETS FROM PRE AND POST JUDGMENT COLLECTON PROCEDURES.

Southern's Response to AG Data Request 4-4 details the company's existing corporate structure. As discussed above, Southern intends to divest its distribution assets as part of the company's ongoing strategy to exit the distribution business and enter "higher growth businesses." Southern Union 10-Q at 15. To this end, Southern has entered into asset and purchase agreements to sell its NEG-RI and PG Energy distribution assets. Id. Southern, further, has intimated a desire to sell its Missouri operations as well, if the purchase of an asset becomes available that will create a like-kind exchange. See Response to AG 1-2(d). Upon the completion of divestiture, Southern will become a pure holding company, with multiple layers of operating subsidiaries. In its envisioned form, Southern's holding company structure will render the interests that the company owns immune from pre and post judgment collection procedures. The State of Rhode Island will be unable, therefore, to satisfy any judgment that it may happen to obtain against Southern in any future remediation action.[4]

[4] Moreover, there is nothing to preclude Southern from further "optimizing" its corporate structure by creating new first and second tier subsidiaries, then merging the current Southern parent into the second tier subsidiary and converting the first tier subsidiary into the new publicly held Southern, so as to compartmentalize the legacy, "stranded liabilities" associated with the natural gas distribution business which Southern is in the process of exiting. *See* discussion *infra*.

While Southern's structure is in a state of flux, see Response to AG Data Request 3-3, Southern's current structure is/will be that of a holding company, with a principal membership interest in Southern Union Panhandle LLC, which is the "manager" of SUG EAT, LLC a Delaware limited liability company. The sole member of SUG EAT, LLC is SUG EAT, Inc., the holder of 99% limited partnership interests, in each of Southern Union Gas Energy, Ltd., a Texas limited partnership, and Southern Union Gas Services, Ltd., a Texas limited partnership.[5] See Response to AG Data Request 4-7. Southern's other principal interest is CCE Acquisition LLC, a limited liability corporation that owns a 50% interest in CCE Holdings, LLC. See Response to AG Data Request 4-4. Southern Union also owns 99% limited partnership interests in SU Pipeline Management LP, Valley Pipeline L.P. and Panhandle Eastern Pipe Line Company, L.P.[6]

Under this and the company's future structure,[7] all of Southern's ownership interests are/will be owned as either LLC's or limited partnerships, *i.e.*, Southern Union Panhandle LLC, SUG EAT LLC (the "managed" entity), CCE Acquisition LLC, SU Pipeline Management L.P., Panhandle Eastern Pipe Line Company, L.P. and Valley

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[5] When the Rhode Island and Pennsylvania transactions are completed, it appears Southern Union will own Southern Union Gas Services through Southern Union Panhandle, LLC. See Response to AG Data Request 3-3.

[6] Panhandle Eastern Pipe Line Company, L.P., in turn, has interests in multiple wholly-owned subsidiaries.

[7] Southern will very likely claim that its ownership of interest in lower tier limited liability interests through ownership of corporate subsidiaries or limited partnership interests is equivalent to ownership of assets. This is not the case, as described below. To the extent such interests are not liquid, they are significantly less amenable to recourse than directly owned assets. More significantly, any increase in the risk of inadequate recourse for the State of Rhode Island resulting from an approval of Southern's proposed transaction in this proceeding conflicts with the public interest which necessarily governs the Division's action on the Joint Application. Southern also offers that legal limits on fraudulent conveyances will provide further comfort to the State. Here again, the relevant question is whether Southern's proposed transaction will increase the State's risk. RIAG submits it will. It is wholly inadequate to maintain that the State's remedy must be, as follows by implication from Southern's contention, ongoing scrutiny and potential litigation of Southern's future corporate restructuring activities to assure against any fraudulent conveyance impairing the State's recourse.

Pipeline Company L.P. Under most, if not all statutes governing limited partnerships and limited liability companies, ***judgment creditors are barred from attaching a corporate entity's interest in a limited partnership or in a limited liability company.*** Lumbermens Mut. Cas. Co., v. Luciano Enterprises, LLC, 2005 WL 2340709 (D. Alaska) ("court may charge partner's interest, but nothing more"). The rationale for prohibiting attachment of these types of interests is simple enough. If attachments of limited partnership or LLC member interests were permitted, the entity's "innocent" partners or members would be unfairly punished and an otherwise stable business would be unduly disrupted. Asset Protection Benefits of LPs and LLCs, Chapter 4 at 23-26.

In lieu of attachment, most limited partnership and LLC state statutes permit judgment creditors to obtain a "Charging Order" against a limited partnership or LLC member interest. E.g., Major Real Estate and Investment Corp. v. Republic Financial Corporation, 695 P.2d 893 (Ct. App. Okla. 1985) (judgment creditor of a general partner in a limited partnership must obtain a charging order to charge the interest of the debtor partner with payment of the unsatisfied amount of the judgment); PB Real Estate, Inc. v. Dem II Properties, 1997 WL 625465 (Conn. Super. Ct. 1997), aff'd on other grounds 719 A.2d 73 (1998) (judgment creditor of LLC has only rights of assignee of partnership interest – payment to debtor had to be characterized as distribution subject to charging order). See also G.L. § 7-13-42 and § 7-16-37. What this means is that the judgment creditor possesses the right to receive whatever distributions of profits the limited partner or LLC member is entitled to receive. However, general partners of limited partnerships and LLC members can cease distributing income to the entity's members. The creditor

cannot force the general partner or LLC members to distribute income, thereby rendering the Charging Order ineffective. One authority explains:

> The sole remedy of the judgment creditor of a partner is a Charging order. This effectively limits a creditor's ability to reach partnership assets. A charging order under the [Revised Uniform Limited Partnership Act] RULPA places the judgment creditor in the position of an assignee of the debtors partner's ownership interest in the partnership. Under the RULPA, an assignee has none of the rights of a partner In the limited partnership: he cannot vote on partnership matters, he cannot see the partnership's books and records, he cannot reach any assets owned by the partnership, and he cannot sell or foreclose on the partnership interest. What does the creditor get under the charging order? He gets the right to any partnership distribution which would have otherwise been paid to the debtor partner – if, as, and when they are made. Guess who decides when those distributions are made? You do!

Asset Protection News, Vol. IV, No. 1 (January, 1995). The same principles apply equally as well to LLC interests. Asset Protection Benefits of LPs and LLCs, Chapter 4 at 26-27 (under most state LLC laws, a creditor's remedy is also limited to a charging order).

The following case study further explains how the LLC or limited partnership corporate form protects assets from pre and post judgment attachment procedures:

> The most powerful weapon of a potential legal adversary is the ability to freeze your assets . . . A judgment lien applies if the plaintiff receives an award in his favor . . . A creditor with a judgment lien clearly holds all of the cards. You have no leverage and no room to negotiate. At this point he has got you. You are trapped and there is no way out. Certainly that is not the position you want to be in when you deal with an adversary. One of our clients, Ed, was a wealthy real estate investor and owned five apartment buildings worth about $3 million. Although he was involved in a lawsuit concerning a property dispute at the time, he felt he had little exposure. We set up a plan for him using several LLCs to hold the properties. A year later we received a call from Ed telling us that he had lost the case and there was a judgment against him for $1.5 million. Had he not set up the plan

> he would have been in big trouble. The plaintiff would have had a lien on all of the client's real estate, worth $3 million, as security for the judgment. The property would have been frozen and then seized. The plaintiff would not have taken a penny less than the full amount of the judgment. Nothing to talk about or discuss-just pay up. That's a bad position to be in.
>
> But because Ed was a smart guy, he was not in a bad position. Since all of his assets had been transferred into the plan, the judgment lien did not affect the properties . . . Since the creditor had no security for his judgment and stood to collect nothing, Ed now had the leverage to negotiate a favorable settlement. He held all of the chips, and in fact, he settled the case for $75,000-clearly a better result than losing the $1.5 million.

The Asset Protection Law Center, Attachments and Liens (July 5, 2006).

And yet another example forcefully conveys the protection that LLC and limited partnership forms afford Southern:

> George and Larry form an investment limited partnership, "GL Global Partners." George contributes $50,000 cash as general partners for a 5% interest in the partnership. Larry, as limited partner contributes $950,000 cash for a 95% limited partnership interest. George and Larry sign a limited partnership agreement which gives George the sole discretion of whether to distribute profits or reinvest them.
>
> Let's suppose that Larry is a dentist and his hygienist accidentally cuts out Connie Creditor's tongue while performing a routine cleaning. Connie sues Larry and gets a $1,000,000 judgment, which exceeds his malpractice policy by $200,000. Larry's only asset is his limited partnership share, worth $950,000. Let's suppose that the partnership is showing an annual $100,000 profit. Larry's share of the profit is $95,000 per year. Connie's lawyer gets a charging order from a judge and serves it on George, the general partner, demanding that Connie receive the $95,000. George decides that the partnership would be better off reinvesting the money than distributing it. Since nothing is being distributed to Larry, Connie gets nothing. Larry is now in a good position to settle with Connie for pennies on the dollar.

Asset Protection Benefits of LPs and LLCs, Chapter 4 at 24-25.

If the pending transaction is approved without the Division's imposing the Conditions, the State will find that its efforts to satisfy the judgment completely futile. Pursuant to the aforementioned principles of partnership and LLC law, the State of Rhode Island will be unable to secure any assets with which to satisfy the judgment because a fully reorganized Southern holds and will hold all of its operating assets through limited partnership or LLCs interests, *i.e.,* Southern Union Panhandle LLC, SUG EAT LLC (the "managed" entity), CCE Acquisition LLC, SU Pipeline Management L.P., Panhandle Eastern Pipe Line Company, L.P. and Valley Pipeline Company L.P. Creditors simply cannot attach these so-called "interests" [8] of Southern to satisfy a judgment. And a charging order, as shown above, will provide no utility to the State of Rhode Island. Southern's subsidiary LLCs and limited partnerships can simply reinvest their money rather than distributing it to Southern. Accordingly, the State's only recourse will be to accept pennies on the dollar from Southern; the remaining cost of the Tiverton remediation will fall on the backs of the Rhode Island taxpayers.

By contrast, as long as Southern's assets remain in Rhode Island, the State's position is akin to that of a "secured creditor" of the Tiverton liability.[9] Immediately, upon entry of judgment (or before should the vagaries of the natural gas market destabilize Southern's current financial condition), the State may immediately secure those assets via attachments for the purpose of satisfying any judgment. Once the assets

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[8] Mr. Sussler further opines that these LLC and limited partnership interests may hold little value for Rhode Island because such interests are illiquid or unmarketable. 6/30/2006 Transcript at 164-65 & 167. Accordingly, their value may be substantially less than the value of the underlying operating assets of the company.

[9] And Southern, because it is a Rhode Island public utility as defined in § 39-1-2, should not be able to encumber Rhode Island operating assets without Division regulatory approval. G.L. § 39-3-15.

are secured, the State can be completely confident that 100% of the entire Judgment will be paid. [10]

Approval of the pending transaction without the Conditions transforms the State from an effective secured creditor to an unsecured judgment creditor, with no recourse, should Southern, in its sole discretion, refuse to satisfy any judgment rendered against the company. Approval of the proposed NEG-RI asset sale without imposing the Conditions, therefore, materially and substantially increases the risk that the State will be required to pick up the $55 million clean-up bill for the Tiverton contamination site. Regulatory approval that creates such risk is not only contrary to the public interest, but also, constitutes a gross abuse of discretion, is clearly erroneous as a matter of law, and arbitrary and capricious.

B. NO ASSURANCE EXISTS THAT SOUTHERN'S CURRENT FINANCIAL CAPACITY WILL BE AVAILABLE TO PAY FOR THE TIVERTON LIABILITY IN THE FUTURE.

Southern contests the need for any condition to an order of the Division approving its sale of its Rhode Island properties, which establishes a specific remedy with regard to the Bay Street, Tiverton matter. Southern premises its objection on the grounds that: (a) under its current corporate structure, Southern, the top-level, publicly-traded parent company, bears the legal responsibility, if established, for the contamination existing at Bay Street, Tiverton incurred by FRG; and (b) the financial status of Southern, as currently structured, is such that it has more than sufficient assets and sources of financing to pay for the costs of Southern liability, assuming liability can be established

[10] Whether through the collection process or in bankruptcy, a secured creditor typically receives 100% payment of the obligation due and owing, as he can always liquidate the collateral to pay the debt.

and the costs of Southern liability are no greater than the range of cost estimates incorporated in the stipulation filed by National Grid, RIDEM, the Town of Tiverton and the Attorney General.

Southern's contentions, however, are entirely misplaced. There are more than sufficient reasons for attaching as a condition to any approval which requires the establishment by Southern from the pending sale proceeds of an escrow for the benefit of the State of Rhode Island with respect to the Bay Street Area environmental remediation.

As articulated by the Attorney General and through the testimony of Mr. Sussler, the evolving case law construing "successor liability" of corporations for environmental contamination provides a much greater level of certainty and protection than before for successor corporations from liability for environmental contamination resulting from the operations of the same business in a different predecessor corporate form. An asset purchase by a purchasing company is now a much more certain means of wiping away any attendant environmental liability which the corporation would otherwise be required to assume due to the past operations of the acquired business. According to Mr. Sussler:

> a critical change happened in successor liability when the Supreme Court decided the Best Foods case . . . prior to Best Foods . . . many courts had a fairly broad view of successor liability. So that companies from their perspective were at risk even with an asset purchase . . . might jump over the seller and reach the buyer. Best Foods changed that. Best Foods said, no, we're going to take traditional corporate law doctrine and if it's an asset purchase . . . then they [the purchasers] will not step into many of the liabilities that were incurred by the selling corporation.

6/30/06 Tr. at 84-85.

In the case of the pending transaction, Mr. Sussler proceeds to explain: "This rule elaborated in Best Foods now becomes—if before it was a sword, now it becomes a

shield. It becomes a planning tool that corporations can utilize to structure their liabilities and assets to reduce and mitigate liabilities. 6/30/06 Tr. at 87. Mr. Sussler concluded by stating "... I am describing risks, no definitive black and white choices of full recourse or no recourse against Southern. ***These risks, my testimony maintains, are significant.*** 6/30/06 Tr. at 87. (Emphasis added).

In acting on the joint petition for approval of the sale of Southern's Rhode Island assets and assuring that any approval of the proposed transaction is consistent, as it must be, with the public interest, the Division is required to make a reasoned estimate regarding the incentives bearing on Southern in the future which will affect its behavior in responding to the Bay Street Area environmental matter. It is not enough given the gravity of the Division's charge to rely only on Southern's assertions of its current plans, especially where Southern has not restricted its future flexibility of action in any respect. The Division must look beyond Southern's currently stated plans and make some reasonable judgments about the intermediate and longer-term operating environment which Southern faces and the feasible options it has which, if exercised, may, in fact, undermine the State's ability to establish, enforce and collect upon such liability.

Southern's stated plan in this proceeding is to create a Massachusetts subsidiary to hold the former FRG assets. This is in the context of Southern's ambitious plan over the last several years to transform itself from a gas distribution company into a gas pipeline company.[11] Given the accomplished sale of the Texas gas distribution business (which

[11] As adduced from the testimony of Mr. Marshall, the company has been on an aggressive track of selling off its gas distribution companies and acquiring pipeline companies. In 2000, Southern's core and primary business was gas distribution; now after multiple sales and purchases of assets or interests in corporations or limited partnerships only 15% of Southern's net cash flow is due to the gas distribution business. 6/29/06 Transcript at 201.

was Southern's historic base of operations) and the pending sales of the Rhode Island and Pennsylvania gas distribution operations, the remaining Fall River operation seems a likely target for sale consistent with the existing plan. Given the legal rules for environmental liability, a future asset sale of the FRG operations could be accomplished without also transferring the liability to the buyer for the Bay Street environmental matters. As a result, the Bay Street environmental liability will become a "stranded liability" not linked to any operating assets and lacking a basis for regulated rate recovery from any natural gas distribution company business operations.[12]

This critical reasonable future development needs also to be evaluated in light of additional factors bearing on the incentives Southern faces and its future behavior in response to those incentives. These include repeal of the Public Utility Holding Company Act of 1935 ("PUHCA"), Southern's transformation from a natural gas distribution company into a gas pipeline business and the fact that all of its gas pipeline operations are held through limited liability business entities (which was not the case for its distribution operations which previously had to be held at the parent level due to the strictures of the PUHCA). In light of the opportunities that these factors afford Southern, there is no assurance that Southern's current financial heft over the long term will be available to back-stop the Bay Street environmental liability.

First, MGP environmental liability is now a "legacy" cost of the distribution business which Southern is apparently exiting. The size of FRG (with assets less than the

[12] Moreover, given the outsized relationship of the Bay Street environmental remediation cost to FRG's operations, its seems very plausible that Southern would seek to uncouple the sale of the former FRG operations from retention of the liability in order to realize a profit on the sale of its Massachusetts operations.

upper range of the Bay Street environmental matter clean-up cost) is such that these legacy costs are likely no longer linked with productive assets or established rate recovery mechanisms (especially, if as is posited above, the FRG operating assets can be sold in a manner which cuts off the liability for a potential buyer). These costs are now primarily a "cost-center" with no upside. All the incentives Southern faces with respect to these costs is to drive them down and delay any pay-out, thereby enhancing the present value benefit to the company's bottom line. Southern can (and in fact is) effecting this strategy by actively pursuing "aggressive defensive litigation against taking responsibility for the clean-up coupled with an enhanced sale price for the assets," where the purchaser, in all probability, is "freed from this environmental liability." Sussler Direct Testimony at 12.

Second, the repeal of PUHCA opens up broad vistas for Southern's restructuring limited only by the creativity of corporate lawyering. Southern could, for example, establish a new first and second tier subsidiary (subsidiary of the first tier subsidiary) and merge the current top tier Southern with the third tier subsidiary, thereby establishing and moving up the former first tier entity as the new publicly traded holding company (for purposes of the current discussion – "New Southern"); thereafter, Southern could spin off the second tier subsidiary (former Southern parent) which holds the Bay Street liability. This follows directly from the logic of the overall Southern business plan to convert itself into a pipeline company and would be driven by the desire to segregate the various pipeline interests held through subsidiaries of old-Southern and to transfer these interests over to New Southern, formerly the new first tier entity. A similar first step was followed

by W.R. Grace Company in its plan to insulate itself from environmental liability. [13]

The result of this restructuring would neatly transfer the Bay Street Tiverton environmental liabilities out from the current top-tier entity into a much lesser entity and would cut off recourse by the State of Rhode Island to the full company's capitalization cited by Southern as the reason for having no concerns about Southern's "ability to pay". Southern could also defend against claims that these transactions effect a fraudulent conveyance by asserting the separate business rationale that they follow from the on-going transformation of the company from a gas distribution company into a pipeline company. Moreover, if the transactions are effected in advance of any ultimate judgment of liability with respect to the Bay Street environmental matter, Southern could further defend against such claims on the premise that the liability is still unliquidated and uncertain in amount.[14]

In light of the foregoing reasonable scenarios, the preferred way to assure that the State of Rhode Island has adequate recourse to financial resources sufficient to pay for the Bay Street environmental matter is to establish a cash escrow in the amount of the upper range of estimated costs for the clean-up of the Bay Street Area. In this way the State can protect itself from the vagaries of the corporate planning opportunities available to Southern over the long-term which is likely required to resolve the Bay Street Area environmental matter.

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[13] See John Heenan Graceful Maneuvering: Corporate Avoidance Of Liability Through Bankruptcy And Corporate Law, Roscoe Pound Environmental Law Essay Contest Winner 2003, Vermont Journal of Environmental Law (2003). See also, Chrysler Corporation v. Ford Motor Co., 972 F. Supp. 1097 (E.D. Mich. 1997) (parent corporation held liable for environmental contamination; subsidiary which purchased the parent's assets held not liable, premised on fact that the subsidiary's creation had an independent business purpose).

[14] Southern could create further uncertainty and risk for the State by litigating more aggressively the issue of liability so as to extend the period during which the liability remained unliquidated, thereby giving it more time to reduce its exposure through corporate reorganizations.

In many ways the appropriate analogy would be that faced by a home-owner purchasing a house with a hole in the roof. An eminently reasonable remedy would be for the home-owner to insist on an escrow with cash equal to an estimate of the cost to repair the roof delivered at closing. This remedy would apply whether the home was purchased from a small contractor or a publicly-traded national construction firm. The escrow's purpose is to reduce the transaction costs and risk of pursuing the seller otherwise borne by the buyer, and without placing the burden on the buyer of having to monitor the financial health and litigate recovery against the seller. Similar considerations apply here, notwithstanding the greater complexity of the transaction.

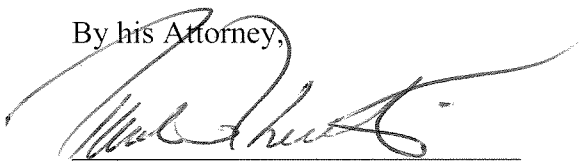
IV. CONCLUSION

For all of the foregoing reasons, the Attorney General requests that the Division approve the pending transaction subject to the conditions enumerated in the Direct Testimony of Philip. L. Sussler, and with a sum deposited in escrow in an amount no less than $55 million.

Respectfully submitted,

PATRICK C. LYNCH,
ATTORNEY GENERAL

By his Attorney,



Paul Roberti
Assistant Attorney General
150 South Main Street
Providence, RI 02903
401-274-4400

CERTIFICATE OF SERVICE

I certify that a copy of the within document was forwarded by electronic mail and by regular mail, postage prepaid, on the 11th day of July, 2006 to the individuals designated on the service list of Docket D-06-13.