

STANDARD &POORS	RATINGS DIRECT
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Research: Southern Union Co.

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Corporate Credit Rating

BBB/Negative/--

Business Profile

1 2 3 **4** 5 6 7 8 9

Financial policy

Aggressive

Debt maturities

2005 \$125 mil.

2006 \$141 mil.

Bank lines/Liquid assets

\$415 million of total bank lines

Total rated debt

About \$2.7 billion

Outstanding Rating(s)

Southern Union Co.

Sr unsecd debt

Local currency

BBB

Sr secd debt

Local currency

A-

Pfd stk

Local currency

BB+

Panhandle Eastern Pipe Line LLC

Corporate Credit Rating

BBB/Negative/--

Sr unsecd debt

Local currency

BBB

Corporate Credit Rating History

Apr. 7, 1998

BBB+

Mar. 7, 2003

BBB

Company Contact

Richard Marshall, Treasurer (570) 829-8795

Major Rating Factors

Strengths:

- Stable earnings,
- Good growth prospects for gas distribution, and
- Ample sources of natural gas for pipelines.

Weaknesses:

- Highly leveraged balance sheet, and
- Dependence on state regulators for adequate allowed return.

Rationale

Southern Union Co.'s corporate credit rating reflects the company's highly leveraged balance sheet and strong business profile. The regulated gas distribution and transportation businesses, which account for 98% of earnings, produce stable and predictable cash flows. The company serves growing markets in

Missouri, Pennsylvania, Rhode Island, and Massachusetts, has limited commodity price risk, and is authorized reasonable rates of return by federal and state regulators. Southern Union has acquired several companies in recent years, a trend the company may continue to follow. However, any acquisitions are expected to be of low-risk, state-regulated gas distribution businesses and federally regulated gas transportation pipelines.

Southern Union's mid-2003 acquisition of Panhandle Eastern Pipeline Co. and its subsidiaries Trunkline Gas Co. LLC and Trunkline LNG Co. LLC and Panhandle's joint venture Sea Robin Pipeline Co. resulted in a highly leveraged consolidated balance sheet. Although Southern Union financed the acquisition with proceeds from selling its Texas gas distribution business and a portion of the proceeds from the sale of common equity and convertible debt, Panhandle Eastern itself had \$1.2 billion of debt. This drove Southern Union's total debt up to 72% of total capital at closing.

Management has committed to rapidly improving its balance sheet. It refinanced Panhandle's debt shortly after the acquisition, lowering interest expense by about \$6 million. In addition, the company issued \$230 million of noncumulative preferred stock, using proceeds to reduce debt. Cash from operations, which management expects to improve by at least \$15 million through the successful integration efforts, including implementation of a new companywide IT platform, together with free cash flow, will be dedicated to debt reduction, as will the proceeds from any future equity sales equity. Furthermore, the company is expected to continue its stock dividend policy, allowing it to build equity through retained earnings.

By the end of 2005, Standard & Poor's expects that the total debt to total capitalization ratio will be appropriate for the 'BBB' rating target benchmark of 56%. Moreover, in 2006, the conversion of \$125 million of debt to equity will lower that ratio to around 50%. Also, by the end of 2005, funds from operations (FFO) should improve to around 16% of average debt, close to the rating target of 17%. Interest coverage ratios will improve as well.

Liquidity.

Liquidity is adequate based on Southern Union's sources of operating cash flow over the next year and committed bank facilities relative to short-term liabilities. The working capital needs of the company are adequately met with a total of \$415 million of committed bank facilities, of which \$163 million was unused at Dec. 31, 2003. The facilities are used primarily to purchase gas for retail customers, and are paid down annually.

The company intends to reduce debt by about \$600 million by the end of 2005. In October 2003, the company issued \$230 million of noncumulative preferred stock. Proceeds were used to pay down \$100 million of trust preferred and remaining funds were used to pay down other debt. Cash and free cash flow are expected to provide another \$250 million to \$280 million. The remainder will come from the sale of equity or assets.

Still, access to the capital markets at reasonable rates will be important as debt matures in each of the coming years: \$125 million in 2005; \$141 million in 2006.

The working capital needs of the company are adequately met with a total of \$415 million of committed bank facilities. The facilities are used primarily to purchase gas for retail customers. The cost of gas, as well as the carrying charge, is fully recovered from natural gas customers in all jurisdictions.

■ Outlook

The negative outlook reflects the execution challenges facing the company in achieving its commitment to deleverage rapidly. Southern Union has been acquisitive for several years, which has resulted in significant and frequent swings in leverage. The company must demonstrate sufficient balance-sheet strength before consummating any future acquisition in order for Standard & Poor's to maintain current ratings.

■ Business Description

Southern Union sells and distributes natural gas to retail customers in Missouri, Pennsylvania, Rhode Island, and Massachusetts. These businesses are divisions of Southern Union. Panhandle Eastern Pipeline, a wholly owned subsidiary, transports natural gas through Panhandle Eastern Pipeline, Trunkline Gas, and Sea Robin Pipeline. Panhandle Pipeline Co. also owns Trunkline LNG, the largest LNG import facility in North America.

Rating Methodology

The corporate credit rating is based on the consolidated business and financial profile of Southern Union and its subsidiaries. The corporate credit rating is assigned to the senior debt at Southern Union, which is itself an operating business, and its subsidiary, Panhandle Eastern Pipe Line LLC. The equal rating of senior debt at each entity reflects Standard & Poor's view that there are substantial parent-level assets relative to liabilities, which obviates the need to notch Southern Union's debt down for structural subordination.

Business Profile

The overall strong business position of Southern Union is defined by growing markets, limited commodity price risk, tight cost controls, and stable and predictable earnings and cash flow from its regulated gas distribution and transmission businesses.

Markets.

The gas distribution businesses serve retail customers in central and western Missouri (Missouri Gas Energy), northeastern and central Pennsylvania (PG Energy), Rhode Island and Massachusetts (New England Gas Co.). In Missouri, where more than one-half the gas is sold, the principal franchises are in Kansas City, a contract that expires in 2010, and St. Joseph, where the franchise is perpetual. In Pennsylvania, where 20% of the gas is sold, statewide service rights are also perpetual. In Rhode Island and Massachusetts, where 29% of gas is sold, New England Gas holds perpetual franchises in Providence and Fall River. Retail demand for natural gas is forecast to increase 1% to 1.5% for residential customers, and slightly more for commercial customers. Transportation for larger customers who buy directly from suppliers is expected to increase 1.5% (Pennsylvania) to 1.75% (Missouri).

The gas transportation business is conducted through two pipelines: Panhandle Eastern Pipeline, which originates in the Anadarko Basin of western Oklahoma and the Panhandle region, transports gas to customers in Missouri, southern Illinois, Indiana, northeastern Ohio and southern Michigan. Trunkline Gas runs the length of the Texas and Louisiana Gulf Coast, and transports gas up the Mississippi Valley through southern Illinois into northern Indiana. Trunkline was originally built to feed Panhandle, and through the 1980s Panhandle was its only customer. But as Panhandle's Missouri and southern Illinois market grew, Trunkline became a more significant direct supplier for the Indiana, Ohio, and Michigan customers. Panhandle, which can deliver 2.7 bcf per day of natural gas, and Trunkline, which can deliver 3.2 bcf per day, supply about 20% of the gas delivered to the upper Midwest markets. The pipelines have a large, long-term customer base. In 2003, about 55% of transportation and storage revenue came from gas distribution utilities and their affiliated marketers, and another 15% came from regional marketers selling to utilities and industrial customers. About 10 customers account for about 65% of the fee-based transportation and storage revenue. Overall, 64% of revenue comes from pipeline reservation fees, 9% from gas storage fees, 6% from firm commodity charges, 6% from interruptible commodity charges, 3% from other services, and 13% from the firm contract with the BG Group for LNG storage capacity in Louisiana. That contract expires in 2023. The LNG facility is being expanded, as is the Trunkline pipeline, under a new long-term contract with BG Group. In addition to having good access to gas basins in the Mid-Continent and the Gulf Coast regions, the pipelines are interconnected with other interstate pipelines in Lebanon, Ohio (Texas Eastern Transmission), Defiance, Ohio (Columbia Gas), and Centerville, Louisiana (Columbia Gulf, Florida Gas Transmission, and Southern Natural Gas Pipeline).

Regulation.

Regulators of the gas distribution companies have allowed generally reasonable returns based on an ROE of around 11%. In November 2003, Missouri Gas Energy filed a base rate increase request for \$54 million. Since the Missouri Public Service Commission (MPSC) can take up to 11 months to make a ruling, new rates may not go into effect until late summer 2004 at the earliest.

The monthly customer bills in all jurisdictions include a fixed service charge that is designed to cover most fixed operating costs and a volumetric charge. Exposure to gas price risk is limited by the purchased gas adjustment mechanism, which allows gas distribution companies to recover the full cost of gas purchased. Various incentive mechanisms require the sharing of cost savings with ratepayers. In Providence, R.I., a weather-normalization clause allows the company to collect the allowed tariff by adjusting the rates up or down depending on the volume of gas sold that is attributable to variations in weather, the single most significant driver in year-to-year sales changes. In Missouri, Missouri Gas Energy is the first energy utility allowed to collect a service connection charge, which is a positive step in modifying rate design. This follows a long period of investment in

replacing all service line connections. The program is currently spending about \$8.5 million per year, down from about \$16 million in 2001.

The pipelines and gas storage operations are regulated by the FERC, which approved tariffs based on an ROE of around 14%. There is no obligation, or need, to seek a rate review. The prevailing rates into the regional end-markets of southern Illinois, Indiana, Ohio, and southern Michigan are about 75% of Panhandle's maximum allowed tariff. A rate moratorium is in effect for Trunkline until May 1, 2004, and for Sea Robin until April 30, 2006. No rate moratorium exists for Panhandle or for Southwest Gas Storage.

Competitive position.

Southern Union's gas distribution businesses enjoy a strong competitive position. In addition to having long-term franchises in the primary cities they serve, they own the only gas distribution network serving their rural and urban customers. The only major competitor is electricity, which is almost always more expensive than gas. Fuel oil and propane also compete, but are not significant. To maintain this competitive advantage, and to mitigate rate increase requests, Southern Union has continued to control operating costs. Three profitable subsidiaries also sell gas-fired appliances and service contracts in the Northeast.

The pipelines face a more competitive market. However, at the end of the cold 2002-2003 winter, competing pipelines were issuing operational flow orders, indicating that they had to retain the gas left in storage for customers with firm contracts. Panhandle and Trunkline, with capacity to spare, were able to meet requests for increased delivery, and were therefore able to charge full tariffs. More importantly, utility regulators saw the need for longer-term gas delivery contracts. As a result, the average delivery contract on Panhandle has increased to 6.5 years, with a few of the largest customers extending out seven and eight years, and at similar or higher rates. Contracts on Trunkline are shorter term, averaging one to two years, but this average is also weighted toward the shorter term because BG Group traditionally sold gas into the spot market and contracted for short-term interruptible use of the pipeline. About one-third of the contracts roll off each year, exposing the company to renewal risk, but also giving management the opportunity to push for longer-term contracts for most of its customers over the next several years.

Most importantly, the management of Panhandle and Trunkline has adopted a sales strategy that provides customers more flexible service while cutting back on operating costs. Contracts are tailored to meet specific capacity and storage requirements; remaining capacity is sold to other customers. Much of the surplus capacity, which occurs in the summer months, is sold to gas-fired electric generating plants. Four years ago, there were only two power plants taking gas directly from the pipeline. Now there are 25, an addition of 11,000 MW. And, the consolidation of operations and a reduction in the number of employees has greatly reduced overall operating costs. Between 1989 and 2002, the number of employees fell to 1,150 from 4,000. Subsequent to the acquisition, the number of employees was again reduced marginally, but more importantly, the operations were consolidated on a single IT platform that will incorporate the gas distribution businesses as well. Annual cost savings are expected to be around \$15 million. Of that, \$10 million had been achieved by the end of 2003.

Financial Policy: Aggressive

Southern Union's management will continue to acquire energy assets, and, as exhibited in the recent acquisition of the Panhandle and Trunkline pipelines, management is not averse to highly leveraged transactions. However, it is expected that acquired assets will have the strong business profile of the companies it currently owns, and that management will sell assets and equity in a timely manner to bring the financial profile back in line with the targets for an investment-grade rating.

Financial Profile

Profitability and cash flow.

The stability of earnings and cash flow over the next several years is supported by reasonable expectations for gradually increased demand for gas in the service territories of the utilities and the pipelines' end-markets. However, it is also based on management's expectation that overall operating costs will be held in line. After the acquisition of each of the utilities, operation and maintenance costs were reduced 25% at Missouri Gas, 21% at PG Energy, and 8% at New England Gas.

Debt reduction will also help keep earnings up and interest coverage ratios in line with an investment-grade rating. FFO (or cash from operations before the changes in working capital) are

expected to cover interest expense by more than 3.5x by the end of 2004, which is stronger than the target benchmark of 2.6x.

Net cash flow (FFO net of preferred dividends) is expected to exceed capital spending by 15% to 20% in the next two years when the Trunkline LNG facility and pipeline are being expanded. Beyond that, net cash flow is expected to be 2.0x to 2.5x capital spending.

Capital structure and financial flexibility.

The acquisition of CMS Panhandle Pipeline added \$1.2 billion to the consolidated financial profile, raising debt-to-capital to 72%. To reduce leverage, management is repaying debt with cash from operations as well as proceeds from the sale of preferred and common stock. Just after the acquisition closed, management refinanced about one-half of Panhandle's debt, lowering overall interest expense. By the end of 2005, Standard & Poor's expects that Southern Union's management will have lowered the ratio of debt/capital to the 'BBB' rating target benchmark of 56%. In 2006, the conversion of \$125 million of debt to equity will lower that ratio further, to around 50%. Accordingly, by the end of 2005, FFO should improve to around 16% of average debt, much closer to the rating target of 17%.

Table 1 Southern Union Co.--Competitors					
Industry Sector: Regulated T&D - Gas					
	--Average of past three fiscal years--				
	Sector median	Southern Union Co.	TXU Gas Co.	Southwest Gas Corp.	UGI Utilities Inc.
Rating		BBB/Stable/--	BBB/Negative/--	BBB-/Stable/--	BBB+/Watch Neg/--
(Mil. \$)					
Sales	923.4	1,351.7	2,913.3	1,250.6	504.1
Funds from operations (FFO)	103.9	122.1	97.3	179.3	78.0
Net income from cont. operations	41.2	35.4	(4.7)	39.8	47.6
Capital expenditures	77.3	105.8	157.3	254.8	37.1
Total debt	608.4	1,194.8	724.0	1,128.8	275.1
Preferred stock	20.0	66.7	148.0	60.0	20.0
Common equity	467.9	714.4	920.7	563.6	232.7
Total capital	1,119.4	1,975.8	1,792.7	1,752.4	527.8
Ratios					
EBIT interest coverage (x)	2.8	1.6	1.0	1.7	5.1
FFO interest coverage (x)	3.1	2.2	2.3	3.1	4.5
FFO/avg. total debt (%)	15.8	11.1	11.2	15.7	27.6
Net cash flow/capital expenditures (%)	77.2	109.4	59.5	60.0	100.8
Total debt/capital (%)	57.0	62.9	45.5	66.2	53.1
Return on common equity (%)	9.9	4.5	(0.9)	6.8	20.0
Common dividend payout (%)	83.0	0.0	0.0	70.6	84.9

Table 2 Southern Union Co.--Financial Summary								
Industry Sector: Regulated T&D - Gas								
	--Average of past three fiscal years--		--12 months ended Dec. 31, 2003--	--Years ended June 30--				
Rating history			BBB/Stable/--	BBB/Stable/--	BBB+/Stable/--	BBB-/Stable/--	BBB+/Stable/--	BBB+/Watch Neg/--
	Sector median	Issuer	2003	2003	2002	2001	2000	1999
(Mil. \$)								
Sales	923.4	1,470.6	1,481.2	1,188.5	1,290.6	1,932.8	831.7	605.2
Funds from operations (FFO)	103.9	161.3	313.7	201.2	150.0	132.7	83.5	94.5

Net income from cont. operations	41.2	43.2	69.1	43.7	19.6	66.2	20.5	20.0
Capital expenditures	77.3	98.9	152.7	79.7	93.3	123.8	100.4	73.1
Total debt	608.4	1,882.1	2,569.6	2,750.4	1,322.2	1,526.1	736.0	414.0
Preferred stock	20.0	33.3	230.0	0	0	100.0	100.0	100.0
Common equity	467.9	775.9	946.5	920.4	685.4	721.9	735.9	301.1
Total capital	1,119.4	2,691.3	3,746.1	3,670.8	2,007.6	2,348.0	1,571.8	815.1
Ratios								
EBIT interest coverage (x)	2.8	1.6	1.7	1.5	1.5	1.8	1.6	1.0
FFO interest coverage (x)	3.1	2.6	3.6	3.0	2.7	2.3	2.6	3.7
FFO/avg. total debt (%)	15.8	10.7	12.3	10.2	9.9	11.3	13.9	21.9
Net cash flow/capital expenditures (%)	77.2	159.9	202.8	252.4	160.8	99.6	73.7	116.2
Total debt/capital (%)	57.0	70.4	68.6	74.9	71.3	65.6	48.0	51.9
Return on common equity (%)	9.9	6.5	7.0	5.4	2.8	7.8	2.1	3.5
Common dividend payout (%)	83.0	0	0	0	0	0	0	0