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Analysis

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Southern Union Company

Risks/Weaknesses

- High levels of absolute debt as a portion of total capitalization.
- Compressed credit measures related to high levels of acquisition debt.
- Historical tendency to grow through various acquisitions involves financial and event risks, even as the company continues integrating the operations of more recent acquisitions.

Opportunities/Strengths

- Low business risk with almost all business lines regulated when calculated on the basis of total assets and the addition of Panhandle's more stable and predictable cash flows and earnings which tend to compensate for the more seasonal variations inherent in the LDC divisions
- Possibility of improved rate designs that could include updated weather normalization clauses and fixed charges in some jurisdictions, helping to protect operating margins from warmer than normal weather patterns.
- No cash dividend on common stock, allowing for internal equity formation and conserving cash to fund capital expenditures, debt repayment, and business reinvestment.

Rating Rationale

Southern Union Co.'s (SUG) Baa3 rating (sr. uns/sr. imp., negative outlook) reflects its low business risk, with little diversification outside its regulated gas distribution and transmission businesses (52% and 48% of assets, respectively as of December 31, 2003). Its regulated rates provide a measure of predictability, but the distribution business is seasonal. The company has mitigated some of the seasonality through weather normalization clauses and more favorable rate designs in its Rhode Island service territories. With the acquisition of Panhandle Eastern Pipe Line Company (Panhandle, Baa3 sr. uns, negative outlook), it is expected that SUG will gross approximately half of its earnings from the gas pipeline transmission business which while mature, is steady and predictable under a regulated price environment. Unlike its LDC diversified peers, SUG pays no cash dividends, allowing internal equity formation. However, the rating also reflects SUG's current high debt and preferred securities level at 77% of total capitalization (factoring in goodwill, operating leases, pension obligations and deferred income taxes) as of December 31, 2003. Until further permanent debt reductions take place, we expect that in the near-term its credit measures will remain compressed from the high levels of debt incurred in acquisitions made over the past few years.

SUG's negative outlook reflects our expectation that SUG's debt reduction progress will be slower than originally anticipated. The outlook will remain negative until SUG achieves its de-leveraging objectives and demonstrates improved returns from the combined companies.

Moody's Investors Service
Global Credit Research

Panhandle's ratings reflect the low business risk as a regulated gas transmission company, earnings stability met through revenues underpinned by flat reservation fees and long-term contracts with a diverse group of creditworthy shippers, a mature asset given some upside by its subsidiary Trunkline LNG Holdings, LLC's LNG facility, and a measure of credit protection provided Panhandle by (i) restricted payments covenants in its indenture, though it still leaves abundant capacity to make a large dividend to SUG and (ii) $260 million of Trunkline LNG project financed non-recourse debt. However, Panhandle's ratings are restrained by higher leverage and weaker coverage measures relative to many of its pipeline company peers (debt-to-capital in the low 60% range and EBIT/interest in 2x range), the prospect of increased capital spending over the medium term from its LNG facility's upcoming $250 million expansion project, a competitive environment that has caused persistent discounting from the pipeline's allowed tariffs, pressuring its ability to earn its allowed returns; above-average re-contracting risk from shorter than industry average contract life of 3.7 years, and an operating record that has yet to be established under SUG's ownership.

The negative outlook for Panhandle mirrors that for SUG, as the parent's efforts to de-leverage and to cut costs could have a credit impact on Panhandle. Execution risk in integrating the two companies is notable, since this acquisition is the largest to-date for SUG, doubling its size and transforming it from a gas distributor to a more diverse gas distribution and transmission company. It is conceivable that over the medium term, SUG will consider issuing additional equity not only to prune the debt heightened by recent acquisitions, but also to fine-tune its strategic focus.

Management Strategy

Southern Union's management team transformed the company in 2003 with the purchase of Panhandle Pipe Line Company and its subsidiaries (which SUG has since renamed Panhandle Energy). In fiscal 2002 and 2003, SUG was primarily a gas distribution company. The acquisition of Panhandle has transformed SUG into a gas distribution and transmission company with consolidated assets split about evenly between these two major segments. With such a large acquisition, SUG management is now focused on integrating the acquired assets and reaching a level of operational and financial performance consistent with its vision for the company. In this endeavor, management has named four primary goals for fiscal 2004 and beyond:

- Integrating acquired operations
- Improving balance sheet and liquidity position
- Achieving earnings targets
- Providing customers with safe and reliable service

Successful Integration Key to the Company's Future

SUG aims to create operational efficiency through the integration of the Panhandle Energy businesses. The company has begun to implement its restructuring and reorganization program and has completed certain phases of its plan in order to fully maximize their cost savings. These integration initiatives include a "shared services initiative" which will streamline back office functions such as information technology, human resources, payroll, etc. The company is contemplating the integration of such functions as regulatory relations and legislative initiatives. SUG's rating is based on a successful integration of the acquired Panhandle businesses.

Over the long term, the possibility of SUG making another major acquisition lends unpredictability to its future financial risk profile. However, Moody's expects that SUG will finance any such acquisition in a manner that will allow it to maintain an investment grade rating.

Improving the Balance Sheet is Key to Maintaining Ratings

Southern Union's leverage remains high at December 31, 2003 with debt to capitalization at 70% (*excluding* the impact of goodwill, operating leases, pension obligations and deferred income taxes) and 77% adjusting for these items with about $2.7 billion of adjusted debt on its balance sheet. For a company of SUG's business mix in the Baa3 rating category, debt to capitalization on an unadjusted basis would be more acceptable around the mid-50% range. SUG indicated that it intended to issue new stock or equity-like securities to help improve its balance sheet, which along with its earnings retention and distribution of stock dividends should help conserve cash and build equity. Toward this end, on October 8, 2003, SUG issued $230 million of 7.55% non-cumulative preferred stock, the proceeds from which were used to repay indebtedness and to redeem $100 million of preferred securities (TOPRs), which were treated as debt in Moody's leverage calculations. SUG management recently indicated that it expects to generate $225 million of free cash flow during its fiscal year ending June 30, 2004. Free cash flow was defined by SUG as the sum of net income, depreciation and working capital changes less capital expenditures exclusive of Trunkline LNG expansion projects. SUG will use the free cash flow generated in fiscal year 2004 to repay indebtedness.

SUG management is also considering the sale of non-core assets to supplement funds for debt reduction. One such asset being contemplated for sale is Sea Robin Pipeline Company, an interstate gas pipeline acquired in the Panhandle Transaction, although it is not expected to yield cash proceeds of any great significance.

Continued Expansion

SUG's LNG import terminal subsidiary, Trunkline LNG, has obtained regulatory approvals from FERC to expand its capacity to 1.2 billion cubic feet (Bcf) per day, approximately double its current sendout capacity, and to increase its storage capacity from 6 Bcf to 9 Bcf. The expansion is expected to be complete by December 31, 2005. In addition, Trunkline LNG is seeking approval from FERC for a second phase expansion of the LNG import terminal, which will increase the sendout capacity to 1.8 Bcf per day. The second phase expansion is expected to be completed by early to mid-2006. The existing and expanded sendout and storage capacity is 100% contracted to BG LNG Services, LLC. Trunkline LNG currently has approximately $260 million of project financed debt outstanding at December 31, 2003. Although this debt is structured without legal recourse to SUG or Panhandle, in Moody's analysis the project financed debt is added to leverage calculations for credit rating purposes.

Rates & Regulation

Southern Union operates in numerous regulatory jurisdictions consisting of about half of its assets under the jurisdiction of FERC and about half by a spade of state regulatory commissions. This regulatory diversity is positive from a ratings perspective because the company is less influenced by the actions of any single regulatory body. SUG actively seeks rate increases in its jurisdictions to achieve satisfactory recovery of its costs. Each of SUG's regulatory jurisdictions has an individual rate design and weather mitigants of varying degrees of effectiveness. The company's future challenge will be to achieve the operating and rate design efficiencies that would enable it to maintain or raise its returns in the jurisdictions in which it operates. Achieving fair rates of return and favorable rate designs would tend to enhance SUG's ability to attract investor capital and deliver stable cash flow and earnings patterns resulting in improved coverage ratios and debt repayment.

Northeast

Approximately 60% of the company's LDC gross margins come from its two northeastern divisions acquired over the last four years. This region serves approximately 460,000 customers.

The Rhode Island Public Service Commission allows New England Gas Company to share incremental earnings with customers when the division's operations return on equity exceeds 11.25% (on a 50%/50% basis for the first percentage point over 11.25% and 75% customer/25% company therafter). The New England Gas Company is allowed to defer the margin impact of weather that is greater than 2%colder-than-normal and will recover the margin impact of weather that is greater than 2% warmer-than-normal.

The Massachusetts Department of Telecommunications and Energy (DTE) allows an 11.25% return on equity (ROE) for Fall River Gas.

To mitigate earnings from the volatility of weather in Pennsylvania, rates have been designed so that customer charges and increased distribution rates are in the first rate block, which has a lower degree of weather-sensitivity.

Missouri

Approximately 40% of the company's LDC gross margins come from its Missouri Gas Energy (MGE) operation which serves approximately 500,000 customers in central and western Missouri.

MGE is regulated by the Missouri Public Service Commission (MPSC), which sets a fairly stringent regulatory environment. On November 4, 2003, MGE filed a proposal with the Missouri Public Service Commission to increase annual base rates by $44.8 million. In January 2004, MGE increased its claim to approximately $54 million. Management has stated that the proposed increase is necessary to allow MGE the opportunity to earn a fair rate of return on the investment made in connection with providing service to its customers. The rate increase is necessary as a result of capital expenditures made since 2001, increased depreciation, taxes and operations and maintenance expenses, declining average usage per customer caused by increased efficiency of heating equipment and conservation and a need for an improved rate of return on MGE's entire investment in rate base. MGE does not have a weather normalization clause, which makes MGE sensitive to weather. MGE is attempting to obtain a fixed charge rate design as that granted to Laclede Gas Company in 2002. This fixed charge rate design would mitigate some of the earnings and cash flow volatility related to weather. Although MGE's prior base rate proceeding was concluded through settlement, if fully-litigated, this proceeding will not be concluded and new rates will not go into effect on October 2004.

Capital Structure

Leverage remains high at the consolidated level with adjusted debt to capital at 77% and unadjusted debt to capital at 70%. Although some of this $2.7 billion adjusted debt burden can be attributed to the Panhandle acquisition, SUG was highly leveraged before it acquired Panhandle from previous LDC acquisitions and incurred large amounts of goodwill through the various transactions. SUG's debt is higher than its diversified LDC peers which average in the mid-50% range. We expect that debt as a portion of total capital to decline as SUG pays down debt through internally generated cash flow and continues to provide internal equity formation as a result of its stock dividend policy. Debt reduction is also possible through the sale of some remaining non-core assets.

The company's equity base has been weak for the last few years with common equity exceeding goodwill at fiscal year end 2003 for the first time since fiscal 2001. Equity was boosted in fiscal year 2003 with the issuance of $175 million of common equity and $125 million of equity units in June 2003 and additional net income of $76 million during the year. Equity was further boosted in October 2003 with the issuance of $230 million of non-cumulative preferred equity. Goodwill is not expected to be impaired and stands strong at $643 million. Moody's backs goodwill out of diversified gas companies' capital bases in the adjusted debt to adjusted capitalization metrics. Hence, the high goodwill balance pressures SUG's leverage.

Also factored into Moody's definition of adjusted debt is underfunded pension liabilities as determined by the gateway decision tree model[2]. For the fiscal year ending 2003, this added about $73 million to SUG's adjusted debt in Moody's analysis. Although medical and pension costs are rising in line with the national trend, SUG's management expects to be required to fund less than $5 million in 2004 as the company determines funding requirements according to ERISA's 80% threshold rule, which all of SUG's pension plans meet.

Panhandle is also highly leveraged with debt to capital around 66%. Moody's expects Panhandle to remain leveraged in the mid-to-low 60% range for the near and intermediate term. These ranges are higher than Panhandle's regulated pipeline peer averages which sit closer to 50%.

Liquidity

SUG has sufficient liquidity with two committed bank facilities: one for $150 million due in April 2004 and another for $225 million due in May 2004. SUG does not utilize a commercial paper program, but instead borrows from its credit facilities for liquidity needs that cannot be met with internally generated cash flow. We expect these facilities will be used mainly for temporary, self-liquidating working capital requirements to purchase gas supply during the winter heating season, although they contain the unfavorable aspect of "material adverse change" clauses. These facilities also carry financial covenants with which the company is currently in compliance including limitations on liens, debt to capital caps, minimum net worth requirements, and coverage ratio thresholds.

Panhandle does not have credit facilities of its own as internally generated cash flow is typically sufficient to meet normal cash needs. Panhandle dividends excess cash up to the parent, supplementing SUG's liquidity.

Southern Union does not operate a corporate money pool given its corporate structure – namely, that the utilities are divisions of the same company and not separate legal entities. Because SUG's distribution divisions are part of the same legal organization, funds are intermingled among the gas utilities. SUG has also agreed with the Missouri Public Service Commission not to loan or invest any funds into Panhandle without prior consent from the commission. Panhandle has its own bank accounts separate from SUG's and its funds are not commingled with those of the gas utilities. Thus far, Panhandle has been cash positive and self-sufficient.

2. *Please see Moody's January 2003 Special Comment Analytical Observations Related to Pension Obligations*

Federal Energy Regulatory Commission

Panhandle Energy is regulated by the Federal Energy Regulatory Commission (FERC). FERC regulates Panhandle with a light hand. There are currently no issues outstanding at the FERC that management expects to have a material impact on the company.

Financial Analysis

Earnings

SUG's LDC business is seasonal, with most of its income earned in the first and fourth calender quarters.

Hence, the company's earnings are weather sensitive, as are those of many other LDCs, since most of its gas volumes are used for space heating. Although SUG employs some weather mitigants in certain jurisdictions to combat the impact of warm weather, these mitigants currently leave approximately 42% of the company's LDC earnings exposed to weather volatility.[1] This percentage of earnings that is subject to earnings variance on account of warmer than normal weather drops to about 15% when the Panhandle earnings are included.

Earnings have begun to creep higher with the acquisition of Panhandle and its subsidiaries. For the twelve months ending December 2003, operating income (excluding "other income/expenses) increased to approximately $101 million from about $50 million at 2003 fiscal year end. Return on assets and return on equity declined somewhat for the same period due to the increase in equity and asset accounts. We expect that these measures will improve as SUG benefits from a full year of Panhandle earnings in fiscal 2004. Once SUG settles into its new business profile as a combination gas distribution and transmission business, we expect earnings to stabilize.

Coverages for SUG consolidated have remained relatively flat since fiscal 2001 with EBIT to interest in the 1.8x range and funds from operations to fixed charge coverage improved modestly over the last few years to 2.7x range as interest rates have decreased, somewhat offsetting the higher levels of interest from an increase in debt outstanding. These coverages are in line with SUG's Baa3 diversified peers. However, we expect coverages to improve as SUG pays down debt levels and achieves a predictable earnings pattern.

Cash Flow

Gross cash flow levels for SUG consolidated are improving, while free cash flow is more volatile. Free cash flow was negative for the twelve months ended September 30, 2003 and 2003 fiscal year end due to negative working capital balances. SUG expects free cash flow to be generally positive going forward, depending on working capital balances. Fortunately, SUG pays stock rather than cash dividends on its common stock, which helps to maximize cash flows available for capital expenditures and to build equity. Moody's views this practice favorably, since it maximizes the cash flows available for capital expenditures and debt reduction, reduces the need for external financing, and helps increase its equity. The stock dividend policy is unusual for a gas utility, which typically pays out most of its earnings and seeks to increase dividends regularly.

Its asset-heavy position has also given rise to high levels of capital expenditures for the twelve months ending September 30, 2003 of around the $100 million range versus about $78 million of depreciation. It is anticipated however, that annual capital expenditure levels for the LDC segment will remain at approximately $70-75 million over the next few years and another $70-75 million for the transmission business, reflecting the Company's commitment to increasing free cash flow. Moody's estimates the level of maintenance capex for both segments to be around 60% of total capital spending during the next few years, excluding special projects such as the Trunkline LNG expansions.

Cash flow to debt coverage is modest for SUG with gross cash flow covering only about 6% of total debt for the twelve months ending September 30, 2003 which compares to a range in the low teens for SUG's Baa3 diversified peers. SUG's current cash flow to debt coverage dropped from 8% - 9% in fiscal 2001 and 2002 with the company's increase in debt burden from the Panhandle acquisition. Because the debt was added on to SUG's consolidated balance sheet at fiscal 2003 year end and annual cash flows were not, there is a lag in the true cash flow to debt for the company. Moody's expects that this coverage will settle out in the low teens range on a steady-state basis.

Panhandle's cash flow is relatively stable with gross cash flow around the $180 million mark for the last couple years. Moody's believes that Panhandle will continue to generate relatively stable cash flows, covering its capital expenditures. This steady stream of internally generated cash will supplement SUG's distribution's business cash flow well, particularly in more volatile weather environments when the distribution segment's cash flow may contain some variability.

1. *See Moody's October 2002 special comment: Negative Rating Trend for Local Gas Distribution Companies: Impact of Diversification and Warm Weather*

Related Research

Special Comments:

Negative Rating Trend For Local Gas Distribution Companies: Impact Of Diversification And Warm Weather, October 2002 (76344)

Moody's Sees Refinancing Risk as Manageable for the Natural Gas Transmission and Distribution Sector, December 2002 (77008)

Diversification Risk Impacts Credit Quality of Gas Distribution Companies, August 2003 (78958)

Industry Outlook:

Diversified Gas Transmission, September 2003 (79462)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Financial Statement Ratios

Financial Statement Ratios: Southern Union Company

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Description	Coupon (%)	Currency	Face Amount (mil)	Maturity	Moody's Rating
Southern Union Company					
SENIOR IMPLIED RATING	—	Domestic	—	—	Baa3
Conv. Sr. Notes	5.750	USD	125	2006	Baa3
Sr. Notes	7.600	USD	475	2024	Baa3
Sr. Notes	8.250	USD	300	2029	Baa3
7.55% Noncum. Perp. Pfd. Stk.	—	USD	230	—	Ba2
Panhandle Eastern Pipe Line Company, LLC					
Sr. Notes	7.875	USD	100	2004	Baa3
Global Senior Notes	6.125	USD	300	2004	Baa3
Senior Global Notes	4.800	USD	300	2008	Baa3
Global Senior Notes	6.500	USD	200	2009	Baa3
Global Senior Notes	8.250	USD	100	2010	Baa3
Senior Global Notes	6.050	USD	250	2013	Baa3
Global Senior Notes	7.000	USD	300	2029	Baa3
415 Shelf Registration	—	USD	300	—	(P)Baa3
415 Shelf Registration	—	USD	200	—	(P)Baa3

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