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HERITAGE PROPANE PARTNERS L P  
Form 8-K  
December 17, 2003

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

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FORM 8-K

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

Date of report (Date of earliest event reported): November 7, 2003

COMMISSION FILE NO. 1-11727

HERITAGE PROPANE PARTNERS, L.P.  
(Exact name of registrant as specified in its charter)

DELAWARE  
(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

73-1493906  
(IRS EMPLOYER IDENTIFICATION NO.)

8801 SOUTH YALE AVENUE, SUITE 310, TULSA, OKLAHOMA 74137  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES AND ZIP CODE)

(918) 492-7272  
(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE)

ITEM 2. ACQUISITION OR DISPOSITION OF ASSETS

On November 7, 2003, we publicly announced the signing of definitive agreements to combine our operations with those of La Grange Energy, L.P., a company engaged in the midstream natural gas business. La Grange Energy conducts its midstream operations through its subsidiary, La Grange Acquisition, L.P., under the name Energy Transfer Company. We refer to Energy Transfer Company as Energy Transfer. Energy Transfer's assets are primarily located in major natural gas producing regions of Texas and Oklahoma.

We are filing this current report on Form 8-K in order to provide additional information regarding this transaction, including information relating to the terms of the transaction, information relating to the business of Energy Transfer, historical financial information relating to Energy Transfer and related entities and pro forma financial statements that give effect to this

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transaction. This information is being filed at this time in part in order to update our Registration Statement on Form S-4 as filed with the Securities and Exchange Commission on November 17, 1997 (Registration No. 333-40407) pursuant to which we issue common units from time to time in connection with acquisitions.

### THE TRANSACTION

The value of this transaction is approximately \$987 million based on the average market price of our common units for the 45 trading days prior to the time we signed the agreements related to the transaction. The agreements related to the transaction provide for the following to occur at the closing of this transaction:

- o La Grange Energy will contribute its interest in Energy Transfer and certain related assets to us in exchange for the following consideration:
  - o An amount in cash equal to \$300 million, less the amount of Energy Transfer debt in excess of \$151.5 million, less accounts payable and other specified liabilities of Energy Transfer, plus an agreed upon amount for the reimbursement of capital expenditures paid by La Grange Energy relating to the Energy Transfer business prior to closing;
  - o the retirement at closing of Energy Transfer's then outstanding debt;
  - o the assumption at closing of Energy Transfer's then existing accounts payable and other specified liabilities;
  - o 12,140,719 of our common units and class D units; and
  - o 3,742,515 special units.
- o La Grange Energy will purchase all of the partnership interests of U.S. Propane, L.P., our general partner, and all of the member interests of U.S. Propane, L.L.C., the general partner of U.S. Propane, L.P., from the current owners for \$30 million in cash. La Grange Energy is owned by Natural Gas Partners VI, L.P., a private equity fund, Ray C. Davis, Kelcy L. Warren and a group of institutional investors.
- o We will acquire from an affiliate of the current owners of our general partner all of the stock of Heritage Holdings, Inc., which owns approximately 4.4 million of our common units, for \$50 million in cash and a \$50 million two-year promissory note secured by a pledge of the units held by Heritage Holdings.

This transaction has not closed and is subject to a number of closing conditions, including the incurrence of new borrowings by Energy Transfer of not less than \$275 million and the receipt by us of net proceeds of not less than \$250 million from public offering of our common units. We expect this transaction to close in January 2004.

### ENERGY TRANSFER

Energy Transfer is a growth-oriented midstream natural gas company with operations primarily located in major natural gas producing regions of Texas and

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Oklahoma. Energy Transfer's primary assets consist of two large gathering and processing systems in the Gulf Coast area of Texas and western Oklahoma and the Oasis Pipeline, an intrastate natural gas pipeline that runs from the Permian Basin in west Texas to natural gas supply and market areas in southeast Texas. Energy Transfer's operations consist of the following:

- the gathering of natural gas from over 1,400 producing wells;
- the compression of natural gas to facilitate its flow from the wells through Energy Transfer's gathering systems;
- the treating of natural gas to remove impurities such as carbon dioxide and hydrogen sulfide to ensure that the natural gas meets pipeline quality specifications;
- the processing of natural gas to extract natural gas liquids, or NGLs; the sale of the pipeline quality natural gas, or "residue gas," remaining after it is processed; and the sale of the NGLs to third parties at fractionation facilities where the NGLs are separated into their individual components, including ethane, propane, mixed butanes and natural gasoline;
- the transportation of natural gas on its Oasis Pipeline to industrial end-users, independent power plants, utilities and other pipelines; and
- the purchase for resale of natural gas from producers connected to its systems and from other third parties.

Energy Transfer owns or has an interest in over 3,850 miles of natural gas pipeline systems, three natural gas processing plants connected to its gathering systems with a total processing capacity of approximately 400 MMcf/d and seven natural gas treating facilities with a total treating capacity of approximately 425 MMcf/d.

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Energy Transfer divides its operations into two business segments, the Midstream segment, which consists of its natural gas gathering, compression, treating, processing and marketing operations, and the Transportation segment, which consists of the Oasis Pipeline.

The Midstream segment consists of the following:

- the Southeast Texas System, a 2,500-mile integrated system located in the Gulf Coast area of Texas, covering 13 counties between Austin and Houston. The system has a throughput capacity of approximately 720 MMcf/d, and average throughput for the 11 months ended August 31, 2003 was approximately 260 MMcf/d. The system includes the La Grange processing plant, which has processing capacity of approximately 240 MMcf/d, and five treating facilities with an aggregate capacity of approximately 250 MMcf/d. Average throughput for the processing plant and the treating facilities was approximately 95 MMcf/d and 80 MMcf/d, respectively, for the 11 months ended August 31, 2003. This system is connected to the Katy Hub, a major natural gas market center near Houston, through Energy Transfer's 55-mile Katy Pipeline and is also connected to the Oasis Pipeline, as well as two power plants.
- the Elk City System, a 315-mile gathering system located in western Oklahoma. The system has a throughput capacity of approximately 410 MMcf/d, and average throughput for the 11 months ended August 31, 2003

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was approximately 170 MMcf/d. The system includes the Elk City processing plant, which has a processing capacity of approximately 130 MMcf/d, and one treating facility with a capacity of approximately 145 MMcf/d. Average throughput for the processing plant was approximately 95 MMcf/d for the 11 months ended August 31, 2003. The Elk City System is connected, either directly or indirectly, to six major interstate and intrastate natural gas pipelines providing access to natural gas markets throughout the United States.

- an interest in various midstream assets located in Texas and Louisiana, including the Vantex System, the Rusk County Gathering System, the Whiskey Bay System and the Chalkley Transmission System. On a combined basis, these assets have a throughput capacity of approximately 265 MMcf/d, and average throughput for these assets was approximately 50 MMcf/d for the 11 months ended August 31, 2003.
- marketing operations through Energy Transfer's producer services business, in which Energy Transfer markets the natural gas that flows through its assets and attracts other customers by marketing volumes of natural gas that do not move through its assets.

The Transportation segment consists of the Oasis Pipeline, a 583-mile natural gas pipeline that directly connects the Waha Hub, a major natural gas market center located in the Permian Basin of west Texas, to the Katy Hub. The Oasis Pipeline is primarily a 36-inch diameter natural gas pipeline. It has bi-directional capability with approximately 1 Bcf/d of throughput capacity moving west-to-east and greater than 750 MMcf/d of throughput capacity moving east-to-west. Average throughput on the Oasis Pipeline was approximately 830 MMcf/d for the 11 months ended August 31, 2003. The Oasis Pipeline has many interconnections with other pipelines, power plants, processing facilities, municipalities and producers.

Energy Transfer has announced that it intends to construct a 78-mile pipeline, which we refer to as the Bossier Pipeline, that will connect natural gas supplies in east Texas to Energy Transfer's Katy Pipeline in Grimes County. The Bossier Pipeline, which is part of our strategy to expand our operations in east Texas, will enable producers to transport natural gas to the Katy Hub from east Texas. Pipeline capacity is constrained in this area due to increasing natural gas production from the ongoing drilling activity in the Barnett Shale in north central Texas and the Bossier Sand and other formations. Energy Transfer has secured contracts with three separate companies to transport natural gas on this pipeline, including a nine-year fee-based contract with XTO Energy, Inc. pursuant to which XTO Energy has committed approximately 200 MMcf/d. We expect the Bossier Pipeline to become commercially operational by mid-2004.

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### THE MIDSTREAM SEGMENT

The Midstream business segment consists of Energy Transfer's natural gas gathering, compression, treating, processing and marketing operations. This segment consists of the Southeast Texas System, the Elk City System, certain other assets in east Texas and Louisiana and Energy Transfer's marketing business.

#### Southeast Texas System

General. The Southeast Texas System is a large natural gas gathering system in the Gulf Coast area of Texas, covering 13 counties between Austin and Houston. The system consists of approximately 2,500 miles of natural gas

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gathering and transportation pipelines, ranging in size from two inches to 30 inches in diameter, the La Grange processing plant and five natural gas treating facilities. The system has a capacity of approximately 720 MMcf/d and average throughput on the system was approximately 260 MMcf/d for the 11 months ended August 31, 2003. Thirty-two compressor stations are located within the system, comprised of 54 units with an aggregate of approximately 42,000 horsepower. Energy Transfer recently relocated an existing compressor to the inlet side of the La Grange processing plant, permitting Energy Transfer to shut down 13 compressors on the gathering system and lower its operating cost.

The Southeast Texas System includes the Katy Pipeline and the La Grange residue line. Energy Transfer's Katy Pipeline is a 55-mile pipeline that connects the Southeast Texas System to the Oasis Pipeline at the Katy Hub and to a third-party storage facility and provides transportation services for gas customers from east and southeast Texas to Katy, Texas. The La Grange residue line connects the outlet side of the La Grange processing plant to the Oasis Pipeline, as well as two natural gas fired power plants.

The La Grange processing plant is a cryogenic natural gas processing plant that processes the rich natural gas that flows through Energy Transfer's system to produce residue gas and NGLs. The plant has a processing capacity of approximately 240 MMcf/d. During the 11 months ended August 31, 2003, the facility processed approximately 95 MMcf/d of natural gas and produced approximately 9,000 Bbls/d of NGLs.

The Southeast Texas System also includes five natural gas treating facilities with aggregate capacity of approximately 250 MMcf/d. Energy Transfer's treating facilities remove carbon dioxide and hydrogen sulfide from natural gas that is gathered into its system before the natural gas is introduced to transportation pipelines to ensure that it meets pipeline quality specifications. Four of its treating facilities are amine treating facilities. The amine treating process involves a continuous circulation of a liquid chemical called amine that physically contacts with the natural gas. Amine has a chemical affinity for hydrogen sulfide and carbon dioxide that allows it to absorb the impurities from the natural gas. Energy Transfer's remaining treating facility is a hydrogen sulfide scavenger facility. This facility uses a liquid or solid chemical that reacts with hydrogen sulfide thereby removing it from the natural gas.

Natural Gas Supply. Energy Transfer currently has approximately 1,050 wells connected to the Southeast Texas System. Approximately 90% of these wells are connected to the western portion of this system, which is located in an area that produces rich natural gas that can be processed and which accounted for approximately 56% of Energy Transfer's throughput on the system for the 11 months ended August 31, 2003. Lean natural gas is generally produced on the eastern portion of the system. The natural gas supplied to the Southeast Texas System is generally dedicated to Energy Transfer under individually negotiated long-term contracts that provide for the commitment by the producer of all natural gas produced from designated properties. Generally, the initial term of such agreements is three to five years or, in some cases, the life of the lease. However, in almost all cases, the term of these agreements is extended for the life of the reserves. Energy Transfer's top two suppliers of natural gas to the Southeast Texas System are Chesapeake Energy Corp. and Anadarko Petroleum Corp., which collectively accounted for approximately 44% of the natural gas supplied to this system for the 11 months ended August 31, 2003. Other suppliers of natural gas to the Southeast Texas System are Clayton Williams, Marathon, Devon Energy Corporation, Duke, Crawford, Stroud and Westport, which represented in the aggregate approximately 38% of the Southeast Texas System's natural gas supply for the 11 months ended August 31, 2003.

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Energy Transfer continually seeks new supplies of natural gas, both to offset natural declines in production from connected wells and to increase throughput volume. Energy Transfer obtains new natural gas supplies in its operating areas by contracting for production from new wells, connecting new wells drilled on dedicated acreage or by obtaining natural gas that has been released from other gathering systems. Although most new wells connected to the Southeast Texas System experience rapid declines in production over the first year or two of production, thereafter they decline at slower rates. Approximately 65% of the natural gas supplied to the Southeast Texas System comes from wells that are older than three years, which are currently not experiencing the rapid declines in production associated with new wells.

Markets for Sale of Natural Gas and NGLs. The Southeast Texas System has numerous market outlets for the natural gas that Energy Transfer gathers and NGLs that it produces on the system. Through Energy Transfer's Katy Pipeline, it transports natural gas to the Katy Hub and has access to all of its interconnecting pipelines. The La Grange residue line is connected to the Oasis Pipeline, as well as the Lower Colorado River Authority Sim Gideon and the Calpine Lost Pines power plants. NGLs from the La Grange processing plant are delivered to the Phillips EZ and Seminole Pipeline Company products pipelines, which are connected to Mont Belvieu, Texas, the largest NGL hub in the United States.

### Elk City System

General. The Elk City System is located in western Oklahoma and consists of over 315 miles of natural gas gathering pipelines, the Elk City processing plant and the Prentiss treating facility. The gathering system has a capacity of approximately 410 MMcf/d and average throughput was approximately 170 MMcf/d for the 11 months ended August 31, 2003. There are five compressor stations located within the system, comprised of 18 units with an aggregate of approximately 19,000 horsepower.

The Elk City processing plant is a cryogenic natural gas processing plant that processes natural gas on the Elk City System to produce residue gas and NGLs. The plant has a processing capacity of approximately 130 MMcf/d. During the 11 months ended August 31, 2003, the facility processed approximately 95 MMcf/d of natural gas and produced approximately 3,600 Bbls/d of NGLs. Energy Transfer's Prentiss treating facility, located in Beckham County, Oklahoma, is an amine treating facility with an aggregate capacity of approximately 145 MMcf/d.

Natural Gas Supply. Energy Transfer currently has approximately 300 wells connected to the Elk City System. Approximately 80% of these wells are connected to the eastern portion of this system, which is located in an area that produces rich natural gas that can be processed and which accounted for approximately 77% of Energy Transfer's throughput on the system for the 11 months ended August 31, 2003. Lean natural gas is generally produced on the western portion of this system. The natural gas supplied to the Elk City System is generally dedicated to Energy Transfer under individually negotiated long-term contracts. The term of such agreements will typically extend for one to six years. The primary suppliers of natural gas to the Elk City System are Chesapeake Energy Corp. and Kaiser-Francis Oil Company and its affiliates, which represented approximately 28% and 25%, respectively, of the Elk City System's natural gas supply for the 11 months ended August 31, 2003.

The Elk City System is located in an active drilling area. Certain producers are actively drilling in the Springer, Atoka and Arbuckle formations in western Oklahoma at depths in excess of 15,000 feet. Energy Transfer recently moved one of its treating plants from Grimes County, Texas to Beckham County,

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Oklahoma to treat natural gas produced in the western portion of the system. Energy Transfer believes that many of the producers drilling in the area will choose to treat their gas through its new treating plant due to the lack of other competitive alternatives.

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Markets for Sale of Natural Gas and NGLs. The Elk City processing plant has access to five major interstate and intrastate downstream pipelines including Natural Gas Pipeline Company of America, Panhandle Eastern Pipeline Co., Reliant Gas Transmission, Northern Natural Gas and Enogex. There are also direct connections to Natural Gas Pipeline Company and Oneok in the field area. The NGLs that Energy Transfer removes are transported on the Koch Hydrocarbons pipeline and delivered for fractionation into Conway, Kansas, a major market center.

### Other Assets

In addition to the midstream assets described above, Energy Transfer owns or has an interest in assets located in Texas and Louisiana. These assets consist of the following:

- Vantex System. Energy Transfer owns a 50% interest in the Vantex natural gas pipeline, a converted 285 mile oil transport line that runs from near the east Texas town of Van to near the Beaumont, Texas industrial area and has a capacity of approximately 100 MMcf/d of natural gas.
- Rusk County Gathering System. Energy Transfer's Rusk County Gathering System consists of approximately 33 miles of natural gas gathering pipeline located in east Texas with a capacity of approximately 15 MMcf/d of natural gas.
- Whiskey Bay System. The Whiskey Bay System consists of approximately 60 miles of gathering pipelines and a 30 MMcf/d processing plant located in south Louisiana east of Lafayette.
- Chalkley Transmission System. Energy Transfer's Chalkley Transmission System is a 32 mile natural gas gathering system located in south central Louisiana and has a capacity of 100 MMcf/d of natural gas.

### Producer Services

Through Energy Transfer's producer services operations, it markets on-system gas and attracts other customers by marketing off-system gas. For both on-system and off-system gas, Energy Transfer purchases natural gas from natural gas producers and other supply points and sells that natural gas to utilities, industrial consumers, other marketers and pipeline companies, thereby generating gross margins based upon the difference between the purchase and resale prices.

Most of Energy Transfer's marketing activities involve the marketing of its on-system gas. For the 11 months ended August 31, 2003, Energy Transfer marketed approximately 524 MMcf/d of natural gas, 86% of which was on-system gas. Substantially all of Energy Transfer's on-system marketing efforts involve natural gas that flows through either the Southeast Texas System or the Oasis Pipeline. Energy Transfer markets only a small amount of natural gas that flows through the Elk City System.

For the off-system gas, Energy Transfer purchases gas or acts as an agent for small independent producers that do not have marketing operations. Energy Transfer develops relationships with natural gas producers to facilitate the

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purchase of their production on a long-term basis. Energy Transfer believes that this business provides Energy Transfer with strategic insights and valuable market intelligence which may impact its expansion and acquisition strategy.

### THE TRANSPORTATION SEGMENT

General. The Oasis Pipeline is a 583-mile, natural gas pipeline that directly connects the Waha Hub in west Texas to the Katy Hub near Houston, Texas. The Oasis Pipeline, constructed in the early 1970's, is primarily a 36-inch diameter natural gas pipeline. The Oasis Pipeline also has direct connections to

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three independent power plants and is connected to two other power plants through the Southeast Texas System. The Oasis Pipeline has bi-directional capability with approximately 1 Bcf/d of natural gas throughput capacity moving west-to-east and greater than 750 MMcf/d of natural gas throughput capacity moving east-to-west. Average throughput was approximately 830 MMcf/d of natural gas for the 11 months ended August 31, 2003. The Oasis Pipeline includes seven mainline compressor stations with approximately 103,000 of installed horsepower.

The Oasis Pipeline is integrated with the Southeast Texas System and is an important component to maximizing the Southeast Texas System's profitability. The Oasis Pipeline enhances the Southeast Texas System:

- by providing Energy Transfer the ability to bypass the La Grange processing plant when processing margins are unfavorable;
- by providing the natural gas on the Southeast Texas System access to other third party supply and market points and interconnecting pipelines; and
- by allowing Energy Transfer to bypass its treating facilities on the Southeast Texas System and blend untreated gas from the Southeast Texas System with gas on the Oasis Pipeline to meet pipeline quality specifications.

Markets and Customers. Energy Transfer generally transports natural gas west-to-east on the Oasis Pipeline. The primary receipt points on the Oasis Pipeline are at the Waha Hub, several third party processing plants, the La Grange processing plant through the La Grange residue line and the Katy Hub. The Oasis Pipeline also takes receipt of natural gas from producers at multiple receipt points along the pipeline. The primary delivery points are at the Waha Hub, three independent power plants located mid-system and the Katy Hub. The Waha and Katy Hubs also connect the Oasis Pipeline to pipelines that provide access to substantially all major U.S. market centers.

The Oasis Pipeline's transportation customers include, among others, the independent power plants connected to the pipeline, other major pipelines, natural gas marketers, natural gas producers and other industrial end-users and utilities. The Oasis Pipeline provides direct service to the 1,100 megawatt, or MW, American National Power Hays County power plant, the 1,000 MW Panda Guadalupe Power Partners power plant and the 850 MW Constellation Rio Nogales power plant, all of which are gas-fired, electric generation facilities with a combined maximum natural gas fuel requirement of approximately 480 MMcf/d. In addition, through the La Grange residue line, the Oasis Pipeline provides service to the Lower Colorado River Authority Sim Gideon and the Calpine Lost Pines units, which have a combined maximum natural gas fuel requirement of approximately 240 MMcf/d. These power plants provide electricity for

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residential, commercial and industrial end-users.

### COMPETITION

Energy Transfer experiences competition in all of its markets. Energy Transfer's principal areas of competition include obtaining natural gas supplies for the Southeast Texas System and Elk City System and natural gas transportation customers for the Oasis Pipeline. Energy Transfer's competitors include major integrated oil companies, interstate and intrastate pipelines and companies that gather, compress, treat, process, transport and market natural gas. The Oasis Pipeline competes directly with two other major intrastate pipelines that link the Waha Hub and the Houston area, one of which is owned by Duke Energy Field Services and the other one of which is owned by El Paso and American Electric Power Service Corporation. The Southeast Texas System competes with natural gas gathering and processing systems owned by Duke Energy Field Services and Devon Energy Corporation. The Elk City System competes with natural gas gathering and processing systems owned by Enogex, Inc., Oneok Gas Gathering, L.L.C., CenterPoint Energy Field Services, Inc. and Enbridge Inc., as well as producer owned systems.

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### REGULATION

Regulation by FERC of Interstate Natural Gas Pipelines. Energy Transfer does not own any interstate natural gas pipelines, so FERC does not directly regulate any of Energy Transfer's pipeline operations pursuant to its jurisdiction under the NGA. However, FERC's regulation influences certain aspects of Energy Transfer's business and the market for Energy Transfer's products. In general, FERC has authority over natural gas companies that provide natural gas pipeline transportation services in interstate commerce and its authority to regulate those services includes:

- the certification and construction of new facilities;
- the extension or abandonment of services and facilities;
- the maintenance of accounts and records;
- the acquisition and disposition of facilities;
- the initiation and discontinuation of services; and
- various other matters.

Failure to comply with the NGA can result in the imposition of administrative, civil and criminal remedies.

In recent years, FERC has pursued pro-competitive policies in its regulation of interstate natural gas pipelines. However, we cannot assure you that FERC will continue this approach as it considers matters such as pipelines' rates and rules and policies that may affect rights of access to natural gas transportation capacity.

Intrastate Pipeline Regulation. Energy Transfer's intrastate natural gas pipeline operations generally are not subject to rate regulation by FERC, but they are subject to regulation by various agencies in Texas, where they are located. However, to the extent that Energy Transfer's intrastate pipeline systems transport natural gas in interstate commerce, the rates, terms and conditions of such transportation service are subject to FERC jurisdiction under

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Section 311 of the NGPA, which regulates, among other things, the provision of transportation services by an intrastate natural gas pipeline on behalf of a local distribution company or an interstate natural gas pipeline. Under Section 311, rates charged for transportation must be fair and equitable, and amounts collected in excess of fair and equitable rates are subject to refund with interest. Failure to comply with the NGPA can result in the imposition of administrative, civil and criminal remedies.

Energy Transfer's intrastate pipeline operations in Texas are subject to the Texas Utilities Code, as implemented by the TRRC. Generally, the TRRC is vested with authority to ensure that rates, operations and services of gas utilities, including intrastate pipelines, are just and reasonable and not discriminatory. The TRRC has authority to ensure that rates charged by intrastate pipelines for natural gas sales or transportation services are just and reasonable. The rates Energy Transfer charges for transportation services are deemed just and reasonable under Texas law unless challenged in a complaint. We cannot predict whether such a complaint will be filed against Energy Transfer or whether the TRRC will change its regulation of these rates. Failure to comply with the Texas Utilities Code can result in the imposition of administrative, civil and criminal remedies.

Gathering Pipeline Regulation. Section 1(b) of the NGA exempts natural gas gathering facilities from the jurisdiction of FERC under the NGA. Energy Transfer owns a number of natural gas pipelines in Texas, Oklahoma and Louisiana that Energy Transfer believes meet the traditional tests FERC has used to establish a pipeline's status as a gatherer not subject to FERC jurisdiction. However, the distinction between FERC-regulated transmission services and federally unregulated gathering services is the subject of substantial, on-going litigation, so the classification and regulation of Energy Transfer's gathering facilities are subject to change based on future determinations by FERC and the courts. State regulation of gathering facilities generally includes various safety, environmental and, in some circumstances, nondiscriminatory take requirements and in some instances complaint-based rate regulation.

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In Texas, Energy Transfer's gathering facilities are subject to regulation by the TRRC under the Texas Utilities Code in the same manner as described above for Energy Transfer's intrastate pipeline facilities. Its operations in Oklahoma are regulated by the Oklahoma Corporation Commission through a complaint based procedure. Under the Oklahoma Corporation Commission's regulations, Energy Transfer is prohibited from charging any unduly discriminatory fees for its gathering services and in certain circumstances is required to provide open access natural gas gathering for a fee. Louisiana's Pipeline Operations Section of the Department of Natural Resources' Office of Conservation is generally responsible for regulating intrastate pipelines and gathering facilities in Louisiana and has authority to review and authorize natural gas transportation transactions and the construction, acquisition, abandonment and interconnection of physical facilities. Historically, apart from pipeline safety, it has not acted to exercise this jurisdiction respecting gathering facilities. Energy Transfer's Chalkley System is regulated as an intrastate transporter, and the Office of Conservation has determined Energy Transfer's Whiskey Bay System is a gathering system.

Energy Transfer is subject to state ratable take and common purchaser statutes in all of the states in which Energy Transfer operates. The ratable take statutes generally require gatherers to take, without undue discrimination, natural gas production that may be tendered to the gatherer for handling. Similarly, common purchaser statutes generally require gatherers to purchase without undue discrimination as to source of supply or producer. These statutes

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are designed to prohibit discrimination in favor of one producer over another producer or one source of supply over another source of supply. These statutes have the effect of restricting Energy Transfer's right as an owner of gathering facilities to decide with whom it contracts to purchase or transport natural gas.

Natural gas gathering may receive greater regulatory scrutiny at both the state and federal levels now that FERC has taken a more light-handed approach to regulation of the gathering activities of interstate pipeline transmission companies and a number of such companies have transferred gathering facilities to unregulated affiliates. For example, the TRRC has approved changes to its regulations governing transportation and gathering services performed by intrastate pipelines and gatherers, which prohibit such entities from unduly discriminating in favor of their affiliates. Many of the producing states have adopted some form of complaint-based regulation that generally allows natural gas producers and shippers to file complaints with state regulators in an effort to resolve grievances relating to natural gas gathering access and rate discrimination. Energy Transfer's gathering operations could be adversely affected should they be subject in the future to the application of state or federal regulation of rates and services. Energy Transfer's gathering operations also may be or become subject to safety and operational regulations relating to the design, installation, testing, construction, operation, replacement and management of gathering facilities. Additional rules and legislation pertaining to these matters are considered or adopted from time to time. We cannot predict what effect, if any, such changes might have on Energy Transfer's operations, but the industry could be required to incur additional capital expenditures and increased costs depending on future legislative and regulatory changes.

**Sales of Natural Gas.** Sales for resale of natural gas in interstate commerce made by intrastate pipelines or their affiliates are subject to FERC regulation unless the gas is produced by the pipeline or affiliate. Under current federal rules, however, the price at which Energy Transfer sells natural gas currently is not regulated, insofar as the interstate market is concerned and, for the most part, is not subject to state regulation. The FERC has proposed rules that would require pipelines and their affiliates who sell gas in interstate commerce subject to FERC's jurisdiction to adhere to a code of conduct prohibiting market manipulation and transactions that have no legitimate business purpose or result in prices not reflective of legitimate forces of supply and demand. The FERC has proposed that those who violate such code of conduct may be subject to suspension or loss of authorization to perform such sales, disgorgement of unjust profits, or other appropriate non-monetary remedies imposed by FERC. We cannot predict the outcome of this proceeding, but do not believe Energy Transfer will be affected materially differently from other intrastate gas pipelines and their affiliates. In addition, Energy Transfer's sales of natural gas are affected by the availability, terms and cost of pipeline transportation. As noted above, the price and terms of access to pipeline transportation are subject to extensive federal and state regulation.

FERC is continually proposing and implementing new rules and regulations affecting those segments of the natural gas industry, most notably interstate natural gas transmission companies, that remain subject to FERC's jurisdiction. These initiatives also may affect the intrastate transportation of natural gas under certain circumstances. The stated purpose of many of these regulatory changes is to promote competition among the various sectors of the natural gas industry and these initiatives generally reflect more light-handed regulation. We cannot predict the ultimate impact of these regulatory changes to Energy Transfer's natural gas marketing operations, and Energy Transfer notes that some of FERC's more recent proposals may adversely affect the availability and

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reliability of interruptible transportation service on interstate pipelines. Energy Transfer does not believe that it will be affected by any such FERC action materially differently than other natural gas marketers with whom it competes.

Pipeline Safety. The states in which Energy Transfer conducts operations administer federal pipeline safety standards under the Natural Gas Pipeline Safety Act of 1968, as amended, which requires certain pipelines to comply with safety standards in constructing and operating the pipelines and subjects the pipelines to regular inspections. Failure to comply with the Act may result in the imposition of administrative, civil and criminal remedies. The "rural gathering exemption" under the Natural Gas Pipeline Safety Act of 1968 presently exempts substantial portions of Energy Transfer's gathering facilities from jurisdiction under that statute. The portions of Energy Transfer's facilities that are exempt include those portions located outside of cities, towns or any area designated as residential or commercial, such as a subdivision or shopping center. The "rural gathering exemption", however, may be restricted in the future, and it does not apply to Energy Transfer's intrastate natural gas pipelines.

### ENVIRONMENTAL MATTERS

The operation of pipelines, plants and other facilities for gathering, compressing, treating, processing, or transporting natural gas, natural gas liquids and other products is subject to stringent and complex laws and regulations pertaining to health, safety and the environment. As an owner or operator of these facilities, Energy Transfer must comply with these laws and regulations at the federal, state and local levels. These laws and regulations can restrict or prohibit Energy Transfer's business activities that affect the environment in many ways, such as:

- restricting the way Energy Transfer can release materials or waste products into the air, water, or soils;
- limiting or prohibiting construction activities in sensitive areas such as wetlands or areas of endangered species habitat, or otherwise constraining how or when construction is conducted;
- requiring remedial action to mitigate pollution from former operations, or requiring plans and activities to prevent pollution from ongoing operations; and
- imposing substantial liabilities on Energy Transfer for pollution resulting from Energy Transfer's operations, including, for example, potentially enjoining the operations of facilities if it were determined that they were not in compliance with permit terms.

In most instances, the environmental laws and regulations affecting Energy Transfer's operations relate to the potential release of substances or waste products into the air, water or soils and include measures to control or prevent the release of substances or waste products to the environment. Costs of planning, designing, constructing and operating pipelines, plants and other facilities must incorporate compliance with environmental laws and regulation and safety standards. Failure to comply with these laws and regulations may trigger a variety of administrative, civil and criminal enforcement measures, which can include the assessment of monetary penalties, the imposition of remedial requirements, the issuance of injunctions and federally authorized citizen suits. Moreover, it is not uncommon for neighboring landowners and other third parties to file claims for personal injury and property damage allegedly caused by the release of substances or other waste products to the environment.

The clear trend in environmental regulation is to place more restrictions

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and limitations on activities that may affect the environment, and thus there can be no assurance as to the amount or timing of future

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expenditures for environmental compliance or remediation, and actual future expenditures may be different from the amounts Energy Transfer currently anticipates. Energy Transfer will attempt to anticipate future regulatory requirements that might be imposed and plan accordingly in order to remain in compliance with changing environmental laws and regulations and to minimize the costs of such compliance.

The following is a discussion of certain environmental and safety concerns that relate to the midstream natural gas and NGLs industry. It is not intended to constitute a complete discussion of all applicable federal, state and local laws and regulations, or specific matters, to which Energy Transfer may be subject.

Energy Transfer's operations are subject to the federal Clean Air Act and comparable state laws and regulations. These laws and regulations govern emissions of pollutants into the air resulting from Energy Transfer's activities, for example in relation to Energy Transfer's processing plants and its compressor stations, and also impose procedural requirements on how it conducts its operations. Such laws and regulations may include requirements that Energy Transfer obtain pre-approval for the construction or modification of certain projects or facilities expected to produce air emissions, strictly comply with the emissions and operational limitations of air emissions permits Energy Transfer is required to obtain, or utilize specific equipment or technologies to control emissions. For example, beginning in mid-2004, increased natural gas supplies from the Bossier Pipeline project will likely require the Katy Compressor Station to run one or both of its turbines. The new clean air plan for Houston will require sources of nitrogen oxides or "NOx" emissions (such as these turbines) to hold "allowances" for each ton of NOx emitted. Energy Transfer currently expects to satisfy this plan requirement between 2004 and 2007 by purchasing annual allowances escalating in cost from \$6,300 in 2004 to \$126,000 in 2007. After 2007, Energy Transfer could make a one-time purchase of a perpetual stream of allowances at a currently estimated cost of approximately \$2.3 million. However, rather than simply making a one-time purchase of a large number of perpetual credits, Energy Transfer believes that there are less costly alternatives for satisfying this plan requirement, such as the installation of selective catalytic reduction equipment coupled with the one-time purchase of a limited amount of NOx emission reduction credits at a combined currently estimated cost of approximately \$1.3 million. Notwithstanding these current plans, Energy Transfer is engaged in negotiations with the Texas Commission on Environmental Quality that could result in the agency granting a variance over a two-year period that would allow Energy Transfer to establish a NOx emissions baseline, such that fewer NOx allowances would have to be purchased by Energy Transfer. In addition, Energy Transfer currently anticipates spending between \$1 million and \$1.5 million prior to 2007 to upgrade its Prairie Lea Compressor Station to comply with recently enacted Texas air permitting regulations. Its failure to comply with these requirements exposes Energy Transfer to civil enforcement actions from the state agencies and perhaps the EPA, including monetary penalties, injunctions, conditions or restrictions on operations and potentially criminal enforcement actions or federally authorized citizen suits.

Energy Transfer's operations generate wastes, including some hazardous wastes, that are subject to the federal Resource Conservation and Recovery Act ("RCRA") and comparable state laws. However, RCRA currently exempts many natural gas gathering and field processing wastes from classification as hazardous

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waste. Specifically, RCRA excludes from the definition of hazardous waste produced waters and other wastes associated with the exploration, development, or production of crude oil, natural gas or geothermal energy. Unrecovered petroleum product wastes, however, may still be regulated under RCRA as solid waste. Moreover, ordinary industrial wastes such as paint wastes, waste solvents, laboratory wastes and waste compressor oils, may be regulated as hazardous waste. The transportation of natural gas and NGLs in pipelines may also generate some hazardous wastes. Although Energy Transfer believes it is unlikely that the RCRA exemption will be repealed in the near future, repeal would increase costs for waste disposal and environmental remediation at Energy Transfer's facilities.

Energy Transfer's operations could incur liability under CERCLA and comparable state laws regardless of Energy Transfer's fault, in connection with the disposal or other release of hazardous substances or wastes, including those arising out of historical operations conducted by Energy Transfer's predecessors. Although "petroleum" as well as natural gas and NGLs are excluded from CERCLA's

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definition of "hazardous substance," in the course of its ordinary operations Energy Transfer will generate wastes that may fall within the definition of a "hazardous substance." CERCLA authorizes the EPA and, in some cases, third parties to take actions in response to threats to the public health or the environment and to seek to recover from the responsible classes of persons the costs they incur. It is not uncommon for neighboring landowners and other third parties to file claims for personal injury and property damage allegedly caused by hazardous substances or other wastes released into the environment. If Energy Transfer was to incur liability under CERCLA, Energy Transfer could be subject to joint and several liability for the costs of cleaning up hazardous substances, for damages to natural resources and for the costs of certain health studies.

Energy Transfer currently owns or leases, and has in the past owned or leased, numerous properties that for many years have been used for the measurement, gathering, field compression and processing of natural gas and NGLs. Although Energy Transfer used operating and disposal practices that were standard in the industry at the time, hydrocarbons or wastes may have been disposed of or released on or under the properties owned or leased by Energy Transfer or on or under other locations where such wastes have been taken for disposal. In addition, some of these properties have been operated by third parties whose treatment and disposal or release of hydrocarbons or wastes was not under Energy Transfer's control. These properties and the substances disposed or released on them may be subject to CERCLA, RCRA and analogous state laws. Under such laws, Energy Transfer could be required to remove or remediate previously disposed wastes (including waste disposed of or released by prior owners or operators) or property contamination (including groundwater contamination, whether from prior owners or operators or other historic activities or spills) or to perform remedial plugging or pit closure operations to prevent future contamination, in some instances regardless of fault or the amount of waste Energy Transfer sent to the site. For example, Energy Transfer is currently involved in several remediation operations in which Energy Transfer's cost for cleanup and related liabilities is estimated to be between \$1.1 million and \$1.8 million in the aggregate. However, with respect to one of the remedial projects, Energy Transfer expects to recover approximately \$500,000 to \$850,000 of these estimated cleanup costs pursuant to a contractual requirement that makes a predecessor owner responsible for environmental liabilities. Energy Transfer has established environmental accruals totaling approximately \$930,000 to address environmental conditions and related

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liabilities including costs for cleanup and remediation of properties.

Energy Transfer's operations can result in discharges of pollutants to waters. The Federal Water Pollution Control Act of 1972, as amended ("FWPCA"), also known as the Clean Water Act, and analogous state laws impose restrictions and strict controls regarding the discharge of pollutants into state waters or waters of the United States. The unpermitted discharge of pollutants such as from spill or leak incidents is prohibited. The FWPCA and regulations implemented thereunder also prohibit discharges of fill material and certain other activities in wetlands unless authorized by an appropriately issued permit. Any unpermitted release of pollutants, including NGLs or condensates, from Energy Transfer's systems or facilities could result in fines or penalties as well as significant remedial obligations. Energy Transfer currently expects to incur costs of approximately \$100,000 over the next year to make spill prevention upgrades or modifications at certain of its facilities as required under its recently updated spill prevention controls and countermeasures or "SPCC" plans.

Energy Transfer's pipelines are subject to regulation by the U.S. Department of Transportation (the "DOT") under the Hazardous Liquid Pipeline Safety Act, or HLPESA, pursuant to which the DOT has established requirements relating to the design, installation, testing, construction, operation, replacement and management of pipeline facilities. The HLPESA covers crude oil, carbon dioxide, NGL and petroleum products pipelines and requires any entity which owns or operates pipeline facilities to comply with the regulations under the HLPESA, to permit access to and allow copying of records and to make certain reports and provide information as required by the Secretary of Transportation. Energy Transfer believes that its pipeline operations are in substantial compliance with applicable HLPESA requirements; however, due to the possibility of new or amended laws and regulations or reinterpretation of existing laws and regulations, there can be no assurance that future compliance with the HLPESA will not have a material adverse effect on Energy Transfer's results of operations or financial positions.

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Currently, the Department of Transportation, through the Office of Pipeline Safety, is in the midst of promulgating a series of rules intended to require pipeline operators to develop integrity management programs for gas transmission pipelines that, in the event of a failure, could impact "high consequence areas". "High consequence areas" are currently defined as areas with specified population densities, buildings containing populations of limited mobility and areas where people gather that occur along the route of a pipeline. Similar rules are already in place for operators of hazardous liquid pipelines, which are also applicable to Energy Transfer's pipelines in certain instances. The Office of Pipeline Safety has yet to publish a final rule requiring gas pipeline operators to develop integrity management plans, but it is expected that a rule will eventually be finalized. Compliance with such rule, or rules, when finalized, could result in increased operating costs that, at this time, cannot reasonably be quantified.

Energy Transfer is subject to the requirements of the Occupational Safety and Health Act, referred to as OSHA, and comparable state laws that regulate the protection of the health and safety of workers. In addition, the OSHA hazard communication standard requires that information be maintained about hazardous materials used or produced in Energy Transfer's operations and that this information be provided to employees, state and local government authorities and citizens. Energy Transfer believes that its operations are in substantial compliance with the OSHA requirements, including general industry standards, record keeping requirements and monitoring of occupational exposure to regulated

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substances.

Energy Transfer does not believe that compliance with federal, state or local environmental laws and regulations will have a material adverse effect on its business, financial position or results of operations. In addition, Energy Transfer believes that the various environmental activities in which it does presently engaged are not expected to materially interrupt or diminish its operational ability to gather, compress, treat, process and transport natural gas and NGLs. We cannot assure you, however, that future events, such as changes in existing laws, the promulgation of new laws, or the development or discovery of new facts or conditions will not cause Energy Transfer to incur significant costs.

### TITLE TO PROPERTIES

Substantially all of Energy Transfer's pipelines are constructed on rights-of-way granted by the apparent record owners of the property. Lands over which pipeline rights-of-way have been obtained may be subject to prior liens that have not been subordinated to the right-of-way grants. Energy Transfer has obtained, where necessary, easement agreements from public authorities and railroad companies to cross over or under, or to lay facilities in or along, watercourses, county roads, municipal streets, railroad properties and state highways, as applicable. In some cases, property on which Energy Transfer's pipeline was built was purchased in fee.

We believe that Energy Transfer has satisfactory title to all of its assets. Record title to some of its assets may continue to be held by affiliates of Energy Transfer's predecessor until Energy Transfer has made the appropriate filings in the jurisdictions in which such assets are located and obtained any consents and approvals that are not obtained prior to transfer. Title to property may be subject to encumbrances. We believe that none of such encumbrances should materially detract from the value of Energy Transfer's properties or from its interest in these properties or should materially interfere with their use in the operation of its business.

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### OFFICE FACILITIES

In addition to Energy Transfer's gathering and treating facilities discussed above, Energy Transfer leases approximately 7,500 square feet of space for Energy Transfer's executive offices in Dallas, Texas. Energy Transfer also leases office facilities in San Antonio, Texas and Tulsa, Oklahoma, which consist of 39,235 square feet and 1,240 square feet, respectively. While Energy Transfer may require additional office space as its business expands, it believes that its existing facilities are adequate to meet its needs for the immediate future and that additional facilities will be available on commercially reasonable terms as needed.

### EMPLOYEES

To carry out its operations, Energy Transfer and its affiliates employs approximately 230 people. Energy Transfer is not party to any collective bargaining agreements. Energy Transfer considers its employee relations to be good.

### LEGAL PROCEEDINGS

On June 16, 2003, Guadalupe Power Partners, L.P. sought and obtained a Temporary Restraining Order that prevents Oasis Pipe Line from taking action to

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restrict Guadalupe Power Partners' ability to deliver and receive natural gas under its contract with Oasis Pipe Line at rates of its choice. In their pleadings, Guadalupe Power Partners alleged unspecified monetary damages for the period from February 25, 2003 to June 16, 2003 and sought to prevent Oasis Pipe Line from implementing flow control measures to reduce the flow of gas to their power plant at varying hourly rates. Oasis Pipe Line filed a counterclaim against Guadalupe Power Partners and asked for damages and a declaration that the contract was terminated as a result of the breach by Guadalupe Power Partners. Oasis Pipe Line and Guadalupe Power Partners agreed to a "stand still" order and referred this dispute to binding arbitration.

Although Energy Transfer may, from time to time, be involved in litigation and claims arising out of its operations in the normal course of business, Energy Transfer is not currently a party to any material legal proceedings. In addition, Energy Transfer is not aware of any material legal or governmental proceedings against Energy Transfer, or contemplated to be brought against Energy Transfer, under the various environmental protection statutes to which Energy Transfer is subject.

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### RISK FACTORS RELATING TO ENERGY TRANSFER

AFTER COMPLETION OF THE ACQUISITION OF ENERGY TRANSFER, THE AMOUNT OF CASH WE WILL BE ABLE TO DISTRIBUTE ON OUR COMMON UNITS PRINCIPALLY WILL DEPEND UPON THE AMOUNT OF CASH WE GENERATE FROM THE OPERATIONS OF ENERGY TRANSFER AND OUR EXISTING PROPANE OPERATIONS.

Under the terms of our partnership agreement, we must pay our general partner's expenses and set aside any cash reserve amounts before making a distribution to our unitholders. After completion of the acquisition of Energy Transfer, the amount of cash we will be able to distribute on our common units principally will depend upon the amount of cash we generate from the operations of Energy Transfer and our existing propane operations. The amount of cash we will generate will fluctuate from quarter to quarter based on, among other things:

- the amount of natural gas transported on the Oasis Pipeline and in Energy Transfer's gathering systems;
- the level of throughput in Energy Transfer's processing and treating operations;
- the fees Energy Transfer charges and the margins it realizes for its services;
- the price of natural gas;
- the relationship between natural gas and NGL prices;
- the weather in our operating areas;
- the cost to us of the propane we buy for resale and the prices we receive for our propane;
- the level of competition from other propane companies and other energy providers; and
- the level of our operating costs.

In addition, the actual amount of cash we will have available for

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distribution will depend on other factors, some of which are beyond our control, including:

- the level of capital expenditures we make;
- the cost of acquisitions, if any;
- our debt service requirements;
- fluctuations in our working capital needs;
- restrictions on distributions contained in our debt agreements;
- our ability to make working capital borrowings under our credit facilities to pay distributions;
- prevailing economic conditions; and
- the amount of cash reserves established by our general partner in its sole discretion for the proper conduct of our business.

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We cannot guarantee that, after our acquisition of Energy Transfer, we will have sufficient available cash each quarter to pay a specific level of cash distributions to our unitholders. You should also be aware that the amount of cash we have available for distribution depends primarily upon our cash flow, including cash flow from financial reserves and working capital borrowings, and is not solely a function of profitability, which will be affected by non-cash items. As a result, we may make cash distributions during periods when we record losses and may not make cash distributions during periods when we record net income.

WE MAY BE UNABLE TO SUCCESSFULLY INTEGRATE THE OPERATIONS OF ENERGY TRANSFER WITH OUR OPERATIONS AND TO REALIZE ALL OF THE ANTICIPATED BENEFITS OF THE ACQUISITION OF ENERGY TRANSFER.

The acquisition of Energy Transfer involves the integration of two companies in separate lines of business that previously have operated independently, which is a complex, costly and time-consuming process. Failure to successfully integrate these two companies may have a material adverse effect on our business, financial condition or results of operations. The difficulties of combining the companies include, among other things:

- operating a significantly larger combined company and adding a new business segment, midstream operations, to our existing propane operations;
- the necessity of coordinating geographically disparate organizations, systems and facilities;
- integrating personnel with diverse business backgrounds and organizational cultures; and
- consolidating corporate and administrative functions.

The process of combining the two companies could cause an interruption of, or loss of momentum in, the activities of the combined company's business and the loss of key personnel. The diversion of management's attention and any delays or difficulties encountered in connection with the acquisition and the integration of the two companies could harm the business, results of operations,

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financial condition or prospects of the combined company after the acquisition. Furthermore, the integration of us and Energy Transfer may not result in the realization of the full benefits anticipated by the companies to result from the acquisition.

ENERGY TRANSFER'S PROFITABILITY IS DEPENDENT UPON PRICES AND MARKET DEMAND FOR NATURAL GAS AND NGLS, WHICH ARE BEYOND ITS CONTROL AND HAVE BEEN VOLATILE.

Energy Transfer is subject to significant risks due to fluctuations in commodity prices. During the 11 months ended August 31, 2003, Energy Transfer generated approximately 54% of its gross margin from three types of contractual arrangements under which its margin is exposed to increases and decreases in the price of natural gas and NGLs -- discount-to-index, percentage-of-proceeds and keep-whole arrangements.

For a portion of the natural gas gathered at the Southeast Texas System and the Elk City System, Energy Transfer purchases natural gas from producers at the wellhead at a price that is at a discount to a specified index price and then gathers and delivers the natural gas to pipelines where it typically resells the natural gas at the index price. Generally, the gross margins it realizes under these discount-to-index arrangements decrease in periods of low natural gas prices because these gross margins are based on a percentage of the index price. Accordingly, a decrease in the price of natural gas could have a material adverse effect on Energy Transfer's results of operations.

For a portion of the natural gas gathered at the Southeast Texas System and the Elk City System, Energy Transfer enters into percentage-of-proceeds arrangements and keep-whole arrangements, pursuant to which it agrees to gather and process natural gas received from the producers. Under percentage-of-proceeds arrangements, it generally sells the residue gas and NGLs at market prices and remits to the producers an agreed upon percentage of the proceeds based on an index price. In other cases, instead of remitting cash payments to the producer, Energy Transfer delivers an agreed upon percentage of the

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residue gas and NGL volumes to the producer and sells the volumes it keeps to third parties at market prices. Under these arrangements, Energy Transfer's revenues and gross margins decline when natural gas prices and NGL prices decrease. Accordingly, a decrease in the price of natural gas or NGLs could have a material adverse effect on its results of operations. Under keep-whole arrangements, Energy Transfer generally sells the NGLs produced from its gathering and processing operations to third parties at market prices. Because the extraction of the NGLs from the natural gas during processing reduces the Btu content of the natural gas, Energy Transfer must either purchase natural gas at market prices for return to producers or make a cash payment to producers equal to the value of this natural gas. Under these arrangements, Energy Transfer's revenues and gross margins decrease when the price of natural gas increases relative to the price of NGLs if it is not able to bypass its processing plants and sell the unprocessed natural gas. Accordingly, an increase in the price of natural gas relative to the price of NGLs could have a material adverse effect on Energy Transfer's results of operations.

In the past, the prices of natural gas and NGLs have been extremely volatile, and we expect this volatility to continue. For example, during the 11 months ended August 31, 2003, the NYMEX settlement price for the prompt month contract ranged from a high of \$9.58 per MMBtu to a low of \$3.72 per MMBtu. A composite of the Mt. Belvieu average NGLs price based upon Energy Transfer's average NGLs composition during the 11 months ended August 31, 2003 ranged from a high of approximately \$0.82 per gallon to a low of approximately \$0.41 per gallon.

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Average realized natural gas sales prices for the 11 months ended August 31, 2003 substantially exceeded Energy Transfer's historical realized natural gas prices as well as recent natural gas prices. For example, Energy Transfer's average realized natural gas price increased \$2.31, or 85.0%, from \$2.72 per MMBtu for the 9 months ended September, 2002 to \$5.03 per MMBtu for 11 months ended August 31, 2003. On December 15, 2003 the NYMEX settlement price for January natural gas deliveries was \$6.95 per MMBtu, which was 38.2% higher than Energy Transfer's average natural gas price for the 11 months ended August 31, 2003. Natural gas prices are subject to significant fluctuations, and there can be no assurance that natural gas prices will remain at the high level recently experienced.

The markets and prices for residue gas and NGLs depend upon factors beyond Energy Transfer's control. These factors include demand for oil, natural gas and NGLs, which fluctuate with changes in market and economic conditions, and other factors, including:

- the impact of weather on the demand for oil and natural gas;
- the level of domestic oil and natural gas production;
- the availability of imported oil and natural gas;
- actions taken by foreign oil and gas producing nations;
- the availability of local, intrastate and interstate transportation systems;
- the availability and marketing of competitive fuels;
- the impact of energy conservation efforts; and
- the extent of governmental regulation and taxation.

ENERGY TRANSFER'S SUCCESS DEPENDS UPON ITS ABILITY TO CONTINUALLY FIND AND CONTRACT FOR NEW SOURCES OF NATURAL GAS SUPPLY.

In order to maintain or increase throughput levels on its gathering and transportation pipeline systems and asset utilization rates at its treating and processing plants, Energy Transfer must continually contract for new natural gas supplies. It may not be able to obtain additional contracts for natural gas supplies. The primary factors affecting Energy Transfer's ability to connect new supplies of natural gas to its gathering systems include its success in contracting for existing natural gas supplies that are not committed to other systems and the level of drilling activity near its gathering systems. The primary factors affecting its ability to attract customers to the Oasis Pipeline include its access to other natural gas pipelines, natural gas

markets, natural gas-fired power plants and other industrial end-users and the level of drilling in areas connected to the Oasis Pipeline.

Fluctuations in energy prices can greatly affect production rates and investments by third parties in the development of new oil and natural gas reserves. Drilling activity generally decreases as oil and natural gas prices decrease. Energy Transfer has no control over the level of drilling activity in the areas of operations, the amount of reserves underlying the wells and the rate at which production from a well will decline, sometimes referred to as the "decline rate." In addition, Energy Transfer has no control over producers or

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their production decisions, which are affected by, among other things, prevailing and projected energy prices, demand for hydrocarbons, the level of reserves, geological considerations, governmental regulation and the availability and cost of capital.

A substantial portion of Energy Transfer's assets, including its gathering systems and its processing and treating plants, are connected to natural gas reserves and wells for which the production will naturally decline over time. In particular, the Southeast Texas System covers portions of the Austin Chalk, Buda, Georgetown, Edwards, Wilcox and other producing formations in southeast Texas, which we collectively refer to as the Austin Chalk trend, and the Elk City System covers portions of the Anadarko basin in western Oklahoma. Both of these natural gas producing regions have generally been characterized by high initial flow rates followed by steep initial declines in production. Accordingly, Energy Transfer's cash flows associated with these systems will also decline unless it is able to access new supplies of natural gas by connecting additional production to these systems. A material decrease in natural gas production in Energy Transfer's areas of operation, as a result of depressed commodity prices or otherwise, would result in a decline in the volume of natural gas it handles, which would reduce its revenues and operating income. In addition, Energy Transfer's future growth will depend, in part, upon whether it can contract for additional supplies at a greater rate than the rate of natural decline in its currently connected supplies.

ENERGY TRANSFER DEPENDS ON CERTAIN KEY PRODUCERS FOR ITS SUPPLY OF NATURAL GAS ON THE SOUTHEAST TEXAS SYSTEM AND THE ELK CITY SYSTEM, THE LOSS OF ANY OF THESE KEY PRODUCERS COULD ADVERSELY AFFECT ITS FINANCIAL RESULTS.

For the 11 months ended August 31, 2003, Anadarko Petroleum Corp. and Chesapeake Energy Corp. supplied Energy Transfer with approximately 44% of the Southeast Texas System's natural gas supply, and Chesapeake Energy Corp. and Kaiser-Francis Oil Company and its affiliates supplied Energy Transfer with approximately 53% of the Elk City System's natural gas supply. To the extent that these and other producers may reduce the volumes of natural gas that they supply Energy Transfer, Energy Transfer would be adversely affected unless it was able to acquire comparable supplies of natural gas from other producers.

LA GRANGE ENERGY MAY SELL UNITS OR OTHER LIMITED PARTNER INTERESTS IN THE TRADING MARKET, WHICH COULD REDUCE THE MARKET PRICE OF UNITHOLDERS' LIMITED PARTNER INTERESTS.

Following the completion of the Energy Transfer transaction, La Grange Energy will own approximately 4,094,798 common units, 8,045,921 class D units and 3,742,515 special units. Following the approval of our unitholders and other conditions, the class D units and special units will be converted into an equal number of common units. In the future, La Grange Energy may dispose of some or all of these units. If La Grange Energy were to dispose of a substantial portion of these units in the trading markets, it could reduce the market price of our outstanding common units. Our partnership agreement allows La Grange Energy to cause us to register for sale units held by La Grange Energy. These registration rights allow La Grange Energy to request registration of its common units, class D units and special units and to include any of those units in a registration of other securities by us.

FEDERAL, STATE OR LOCAL REGULATORY MEASURES COULD ADVERSELY AFFECT ENERGY TRANSFER'S BUSINESS.

As a natural gas gatherer and intrastate pipeline company, Energy Transfer generally is exempt from Federal Energy Regulatory Commission, or FERC, regulation under the Natural Gas Act of 1938, or

NGA, but FERC regulation still significantly affects its business and the market for its products. In recent years, FERC has pursued pro-competitive policies in its regulation of interstate natural gas pipelines. However, we cannot assure you that FERC will continue this approach as it considers matters such as pipeline rates and rules and policies that may affect rights of access to natural gas transportation capacity. In addition, the rates, terms and conditions of some of the transportation services Energy Transfer provides on the Oasis Pipeline are subject to FERC regulation under Section 311 of the Natural Gas Policy Act, or NGPA. Under Section 311, rates charged for transportation must be fair and equitable, and amounts collected in excess of fair and equitable rates are subject to refund with interest.

Energy Transfer's intrastate natural gas transportation pipelines are located in Texas and some are subject to regulation as common purchasers and as gas utilities by the Texas Railroad Commission, or TRRC. The TRRC's jurisdiction extends to both rates and pipeline safety. The rates Energy Transfer charges for transportation services are deemed just and reasonable under Texas law unless challenged in a complaint. Should a complaint be filed or should regulation become more active, its business may be adversely affected.

Other state and local regulations also affect Energy Transfer's business. Energy Transfer is subject to ratable take and common purchaser statutes in Texas, Oklahoma and Louisiana, the states where it operates. Ratable take statutes generally require gatherers to take, without undue discrimination, natural gas production that may be tendered to the gatherer for handling. Similarly, common purchaser statutes generally require gatherers to purchase without undue discrimination as to source of supply or producer. These statutes have the effect of restricting Energy Transfer's right as an owner of gathering facilities to decide with whom it contracts to purchase or transport natural gas. Federal law leaves any economic regulation of natural gas gathering to the states, and some of the states in which Energy Transfer operates have adopted complaint-based or other limited economic regulation of natural gas gathering activities. States in which Energy Transfer operates that have adopted some form of complaint-based regulation, like Oklahoma and Texas, generally allow natural gas producers and shippers to file complaints with state regulators in an effort to resolve grievances relating to natural gas gathering rates and access.

The states in which Energy Transfer conducts operations administer federal pipeline safety standards under the Pipeline Safety Act of 1968, which requires certain pipelines to comply with safety standards in constructing and operating the pipelines, and subjects pipelines to regular inspections. Certain of Energy Transfer's gathering facilities are exempt from the requirements of this Act. In respect to recent pipeline accidents in other parts of the country, Congress and the Department of Transportation have passed or are considering heightened pipeline safety requirements. See "Energy Transfer -- Regulation."

Failure to comply with applicable regulations under the NGA, NGPA, Pipeline Safety Act and certain state laws can result in the imposition of administrative, civil and criminal remedies.

**ENERGY TRANSFER'S BUSINESS INVOLVES HAZARDOUS SUBSTANCES AND MAY BE ADVERSELY AFFECTED BY ENVIRONMENTAL REGULATION.**

Many of the operations and activities of Energy Transfer's gathering systems, plants and other facilities are subject to significant federal, state and local environmental laws and regulations. These include, for example, laws and regulations that impose obligations related to air emissions and discharge of wastes from its facilities and the cleanup of hazardous substances that may have been released at properties currently or previously owned or operated by Energy Transfer or locations to which it has sent wastes for disposal. Various

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governmental authorities have the power to enforce compliance with these regulations and the permits issued under them, and violators are subject to administrative, civil and criminal penalties, including civil fines, injunctions or both. Liability may be incurred without regard to fault for the remediation of contaminated areas. Private parties, including the owners of properties through which Energy Transfer's gathering systems pass, may also have the right to pursue legal actions to enforce compliance as well as to seek damages for non-compliance with environmental laws and regulations or for personal injury or property damage.

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There is inherent risk of the incurrence of environmental costs and liabilities in Energy Transfer's business due to its handling of natural gas and other petroleum products, air emissions related to its operations, historical industry operations, waste disposal practices and the prior use of natural gas flow meters containing mercury. In addition, the possibility exists that stricter laws, regulations or enforcement policies could significantly increase Energy Transfer's compliance costs and the cost of any remediation that may become necessary. Energy Transfer may incur material environmental costs and liabilities. Furthermore, its insurance may not provide sufficient coverage in the event an environmental claim is made against Energy Transfer.

Energy Transfer's business may be adversely affected by increased costs due to stricter pollution control requirements or liabilities resulting from non-compliance with required operating or other regulatory permits. New environmental regulations might adversely affect its products and activities, including gathering, compression, treating, processing and transportation, as well as waste management and air emissions. Federal and state agencies could also impose additional safety requirements, any of which could affect Energy Transfer's profitability. See "Energy Transfer -- Environmental Matters."

ENERGY TRANSFER'S BUSINESS INVOLVES MANY HAZARDS AND OPERATIONAL RISKS, SOME OF WHICH MAY NOT BE FULLY COVERED BY INSURANCE.

Energy Transfer's operations are subject to the many hazards inherent in the gathering, compression, treating, processing and transportation of natural gas and NGLs, including:

- damage to pipelines, related equipment and surrounding properties caused by hurricanes, tornadoes, floods, fires and other natural disasters and acts of terrorism;
- inadvertent damage from construction and farm equipment;
- leaks of natural gas, NGLs and other hydrocarbons; and
- fires and explosions.

These risks could result in substantial losses due to personal injury and/or loss of life, severe damage to and destruction of property and equipment and pollution or other environmental damage and may result in curtailment or suspension of our related operations. Energy Transfer's operations are primarily concentrated in Texas, and a natural disaster or other hazard affecting this area could have a material adverse effect on its operations. Energy Transfer is not fully insured against all risks incident to its business. It does not have property insurance on all of its underground pipeline systems that would cover damage to the pipelines. It is not insured against all environmental accidents that might occur, other than those considered to be sudden and accidental. Energy Transfer has minimal business interruption insurance that covers the

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Oasis Pipeline. If a significant accident or event occurs that is not fully insured, it could adversely affect Energy Transfer's operations and financial condition.

ANY REDUCTION IN THE CAPACITY OF, OR THE ALLOCATIONS TO, ENERGY TRANSFER'S SHIPPERS IN INTERCONNECTING, THIRD-PARTY PIPELINES COULD CAUSE A REDUCTION OF VOLUMES TRANSPORTED IN ITS PIPELINES, WHICH WOULD ADVERSELY AFFECT ENERGY TRANSFER'S REVENUES AND CASH FLOW.

Users of Energy Transfer's pipelines are dependent upon connections to third-party pipelines to receive and deliver natural gas and NGLs. Any reduction of capacities of these interconnecting pipelines due to testing, line repair, reduced operating pressures, or other causes could result in reduced volumes transported in Energy Transfer's pipelines. Similarly, if additional shippers begin transporting volumes of natural gas and NGLs over interconnecting pipelines, the allocations to existing shippers in these pipelines would be reduced, which could also reduce volumes transported in Energy Transfer's pipelines. Any reduction in volumes transported in Energy Transfer's pipelines would adversely affect its revenues and cash flow.

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ENERGY TRANSFER ENCOUNTERS COMPETITION FROM OTHER MIDSTREAM COMPANIES.

Energy Transfer experiences competition in all of its markets. Energy Transfer's principal areas of competition include obtaining natural gas supplies for the Southeast Texas System and Elk City System and natural gas transportation customers for the Oasis Pipeline. Energy Transfer's competitors include major integrated oil companies, interstate and intrastate pipelines and companies that gather, compress, treat, process, transport and market natural gas. The Oasis Pipeline competes directly with two other major intrastate pipelines that link the Waha Hub and the Houston area, one of which is owned by Duke Energy Field Services, LLC and the other one of which is owned by El Paso Corporation and American Electric Power Service Corporation. The Southeast Texas System competes with natural gas gathering and processing systems owned by Duke Energy Field Services, LLC and Devon Energy Corporation. The Elk City System competes with natural gas gathering and processing systems owned by Enogex, Inc., Oneok Gas Gathering, L.L.C., CenterPoint Energy Field Services, Inc. and Enbridge Inc., as well as producer owned systems. Many of Energy Transfer's competitors have greater financial resources and access to larger natural gas supplies than Energy Transfer does.

EXPANDING ENERGY TRANSFER'S BUSINESS BY CONSTRUCTING NEW PIPELINES AND TREATING AND PROCESSING FACILITIES SUBJECTS ENERGY TRANSFER TO CONSTRUCTION RISKS.

One of the ways Energy Transfer may grow its business is through the construction of additions to its existing gathering, compression, treating, processing and transportation system. The construction of a new pipeline or the expansion of an existing pipeline, by adding additional horsepower or pump stations or by adding a second pipeline along an existing pipeline, and the construction of new processing or treating facilities, involve numerous regulatory, environmental, political and legal uncertainties beyond its control and require the expenditure of significant amounts of capital. If Energy Transfer undertakes these projects, they may not be completed on schedule or at all or at the budgeted cost. Moreover, Energy Transfer's revenues may not increase immediately upon the expenditure of funds on a particular project. For instance, if Energy Transfer builds a new pipeline, the construction will occur over an extended period of time, and Energy Transfer will not receive any material increases in revenues until after completion of the project. Moreover, it may construct facilities to capture anticipated future growth in production

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in a region in which such growth does not materialize. As a result, new facilities may not be able to attract enough throughput to achieve Energy Transfer's expected investment return, which could adversely affect its results of operations and financial condition.

ENERGY TRANSFER DEPENDS ON KOCH HYDROCARBONS, L.P. TO PURCHASE AND FRACTIONATE THE NGLS PRODUCED AT THE ELK CITY PROCESSING PLANT.

All of the NGLs produced at the Elk City processing plant are transported by Koch Hydrocarbons and delivered for fractionation to Conway, Kansas. There are no other fractionation plants or other NGL markets connected to the Elk City processing plant. As a result, if Koch Hydrocarbons refuses or is unable to transport or fractionate these NGLs, Energy Transfer's only alternative in the short term would be to transport NGLs by truck to another fractionation plant or another NGL market, which would likely result in additional costs and adversely affect its ability to market the NGLs.

ENERGY TRANSFER IS EXPOSED TO THE CREDIT RISK OF ITS CUSTOMERS, AND AN INCREASE IN THE NONPAYMENT AND NONPERFORMANCE BY ITS CUSTOMERS COULD REDUCE OUR ABILITY TO MAKE DISTRIBUTIONS TO OUR UNITHOLDERS.

Risks of nonpayment and nonperformance by Energy Transfer's customers are a major concern in its business. Several participants in the energy industry have been receiving heightened scrutiny from the financial markets in light of the collapse of Enron Corp. Energy Transfer is subject to risks of loss resulting from nonpayment or nonperformance by its customers. Any increase in the nonpayment and nonperformance by its customers could reduce our ability to make distributions to our unitholders.

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ENERGY TRANSFER MAY NOT BE ABLE TO BYPASS THE LA GRANGE PROCESSING PLANT, WHICH WOULD EXPOSE ENERGY TRANSFER TO THE RISK OF UNFAVORABLE PROCESSING MARGINS.

Because of Energy Transfer's ownership of the Oasis Pipeline, it can generally elect to bypass the La Grange processing plant when processing margins are unfavorable and instead deliver pipeline-quality gas by blending rich gas from the Southeast Texas System with lean gas transported on the Oasis Pipeline. In some circumstances, such as when Energy Transfer does not have a sufficient amount of lean gas to blend with the volume of rich gas that it receives at the La Grange processing plant, Energy Transfer may have to process the rich gas. If it has to process when processing margins are unfavorable, Energy Transfer's results of operations will be adversely affected.

ENERGY TRANSFER MAY NOT BE ABLE TO RETAIN EXISTING CUSTOMERS OR ACQUIRE NEW CUSTOMERS, WHICH WOULD REDUCE ITS REVENUES AND LIMIT ITS FUTURE PROFITABILITY.

The renewal or replacement of existing contracts with Energy Transfer's customers at rates sufficient to maintain current revenues and cash flows depends on a number of factors beyond its control, including competition from other pipelines, and the price of, and demand for, natural gas in the markets it serves.

For the 11 months ended August 31, 2003, approximately 23% of Energy Transfer's sales of natural gas were to industrial end-users and utilities. As a consequence of the increase in competition in the industry and volatility of natural gas prices, end-users and utilities are increasingly reluctant to enter into long-term purchase contracts. Many end-users purchase natural gas from more than one natural gas company and have the ability to change providers at any time. Some of these end-users also have the ability to switch between gas and

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alternate fuels in response to relative price fluctuations in the market. Because there are numerous companies of greatly varying size and financial capacity that compete with Energy Transfer in the marketing of natural gas, Energy Transfer often competes in the end-user and utilities markets primarily on the basis of price. The inability of Energy Transfer's management to renew or replace its current contracts as they expire and to respond appropriately to changing market conditions could have a negative effect on its profitability.

ENERGY TRANSFER HAS A LIMITED OPERATING HISTORY.

Energy Transfer acquired substantially all of its assets in October 2002 and December 2002 and has therefore only operated them together under common management for a limited period of time. Furthermore, the success of Energy Transfer's business strategy is dependent upon its operating these assets substantially differently from the manner in which Aquila Gas Pipeline operated them. As a result, Energy Transfer's historical and pro forma financial information may not give you an accurate indication of what its actual results would have been if Energy Transfer had completed the acquisitions at the beginning of the periods presented or its future results of operations. If Energy Transfer is unable to operate these assets in accordance with Energy Transfer's business strategy, it will have a material adverse effect on Energy Transfer's results of operations.

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

### ENERGY TRANSFER

Energy Transfer is a Texas limited partnership formed in September 2002 to own, operate and acquire midstream assets from Aquila Gas Pipeline, an affiliate of Aquila, Inc. Energy Transfer's operations are concentrated in the Austin Chalk trend of southeast Texas, the Anadarko Basin of western Oklahoma and the Permian Basin of west Texas. It divides its operations into the following two business segments:

- Midstream Segment, which focuses on the gathering, compression, treating, processing and marketing of natural gas, primarily in the Southeast Texas System and the Elk City System. For the 11 months ended August 31, 2003, approximately 72% of Energy Transfer's gross margin was derived from this segment.

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- Transportation Segment, which focuses on the transportation of natural gas through the Oasis Pipeline. For the 11 months ended August 31, 2003, approximately 28% of Energy Transfer's gross margin was derived from this segment.

During the 11 months ended August 31, 2003, Energy Transfer generated approximately 46% of its gross margin from fees it charged for providing its services, including a transportation fee it charges the producer services business for natural gas that the producer service business transports on the Oasis Pipeline equal to the fee it charges third parties. This transportation fee accounted for 7% of its total gross margin for this period. Energy Transfer generated the remaining 54% of its gross margin from discount-to-index, percentage-of-proceeds and keep-whole arrangements and from its producer services business. We intend to seek to increase the percentage of Energy Transfer's business conducted under fee-based arrangements in order to reduce our exposure to increases and decreases in the price of natural gas and NGLs. However, in order to remain competitive, Energy Transfer will need to offer

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other contractual arrangements to attract certain natural gas supplies to its systems.

### The Midstream Segment

Results from the Midstream segment are determined primarily by the volumes of natural gas gathered, compressed, treated, processed, purchased and sold through Energy Transfer's pipeline and gathering systems and the level of natural gas and NGL prices. Energy Transfer generates its revenues and its gross margins principally under the following types of arrangements:

**Fee-based arrangements.** Under fee-based arrangements, Energy Transfer receives a fee or fees for one or more of the following services: gathering, compressing, treating or processing natural gas. The revenue it earns from these arrangements is directly related to the volume of natural gas that flows through its systems and is not directly dependent on commodity prices. To the extent a sustained decline in commodity prices results in a decline in volumes, however, its revenues from these arrangements would be reduced.

**Other arrangements.** Energy Transfer also utilizes other types of arrangements in its Midstream segment, including:

- **Discount-to-index price arrangements.** Under discount-to-index price arrangements, Energy Transfer generally purchases natural gas at either (1) a percentage discount to a specified index price, (2) a specified index price less a fixed amount or (3) a percentage discount to a specified index price less an additional fixed amount. It then gathers and delivers the natural gas to pipelines where it resells the natural gas at the index price. The gross margins Energy Transfer realizes under the arrangements described in clauses (1) and (3) above decrease in periods of low natural gas prices because these gross margins are based on a percentage of the index price.
- **Percentage-of-proceeds arrangements.** Under percentage-of-proceeds arrangements, Energy Transfer generally gathers and processes natural gas on behalf of producers, sells the resulting residue gas and NGL volumes at market prices and remits to producers an agreed upon percentage of the proceeds based on an index price. In other cases, instead of remitting cash payments to the producer, Energy Transfer delivers an agreed upon percentage of the residue gas and NGL volumes to the producer and sells the volumes it keeps to third parties at market prices. Under these types of arrangements, Energy Transfer's revenues and gross margins increase as natural gas prices and NGL prices increase, and its revenues and gross margins decrease as natural gas prices and NGL prices decrease.
- **Keep-whole arrangements.** Under keep-whole arrangements, Energy Transfer gathers natural gas from the producer, processes the natural gas and sells the resulting NGLs to third parties at market prices. Because the extraction of the NGLs from the natural gas during processing reduces the Btu content of the natural gas, Energy Transfer must either purchase natural gas at market prices for return to producers or make a cash payment to the producers equal to the value of this natural gas. Accordingly, under these arrangements, Energy Transfer's revenues and gross margins increase as

the price of NGLs increases relative to the price of natural gas, and its revenues and gross margins decrease as the price of natural gas increases relative to the price of NGLs. In the latter case, Energy Transfer is

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generally able to reduce its commodity price exposure by bypassing its processing plants and not processing the natural gas, as described below.

In many cases, Energy Transfer provides services under contracts that contain a combination of more than one of the arrangements described above. The terms of its contracts vary based on gas quality conditions, the competitive environment at the time the contracts are signed and customer requirements. Its contract mix and, accordingly, its exposure to natural gas and NGL prices, may change as a result of changes in producer preferences, its expansion in regions where some types of contracts are more common and other market factors.

A significant benefit of Energy Transfer's ownership of the Oasis Pipeline is that Energy Transfer typically can elect not to process the natural gas at the La Grange processing plant when processing margins are unfavorable. Instead of processing the natural gas, Energy Transfer is able to bypass the La Grange processing plant and deliver natural gas meeting pipeline quality specifications by blending rich natural gas from the Southeast Texas System with lean natural gas transported on the Oasis pipeline.

Energy Transfer can also generally bypass the Elk City processing plant. The natural gas supplied to the Elk City System has a relatively low NGL content and does not require processing to meet pipeline quality specifications. During periods of unfavorable processing margins, Energy Transfer can bypass the Elk City processing plant and deliver the natural gas directly into connecting pipelines.

Energy Transfer conducts its marketing operations through its producer services business, in which Energy Transfer markets the natural gas that flows through its assets, which Energy Transfer refers to as on-system gas, and attracts other customers by marketing volumes of natural gas that do not move through its assets, which Energy Transfer refers to as off-system gas. For both on-system and off-system gas, Energy Transfer purchases natural gas from natural gas producers and other supply points and sells that natural gas to utilities, industrial consumers, other marketers and pipeline companies, thereby generating gross margins based upon the difference between the purchase and resale prices.

Most of Energy Transfer's marketing activities involve the marketing of its on-system gas. For the 11 months ended August 31, 2003, Energy Transfer marketed approximately 524 MMcf/d of natural gas, 86% of which was on-system gas. Substantially all of its on-system marketing efforts involve natural gas that flows through either the Southeast Texas System or the Oasis Pipeline. Energy Transfer markets only a small amount of natural gas that flows through the Elk City System.

For its off-system gas, Energy Transfer purchases gas or acts as an agent for small independent producers that do not have marketing operations. Energy Transfer develops relationships with natural gas producers which facilitates its purchase of their production on a long-term basis. Energy Transfer believes that this business provides it with strategic insights and valuable market intelligence which may impact its expansion and acquisition strategy.

### The Transportation Segment

Results from Energy Transfer's Transportation segment are determined primarily by the amount of capacity Energy Transfer's customers reserve as well as the actual volume of natural gas that flows through the Oasis Pipeline. Under Oasis Pipeline customer contracts, Energy Transfer charges its customers a demand fee, a transportation fee, or a combination of both, generally payable monthly.

- Demand Fee. The demand fee is a fixed fee for the reservation of an agreed amount of capacity on the Oasis Pipeline for a specified period of

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time. The customer is obligated to pay Energy Transfer the demand fee even if the customer does not transport natural gas on the Oasis Pipeline.

- Transportation Fee. The transportation fee is based on the actual throughput of natural gas by the customer on the Oasis Pipeline.

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For the 11 months ended August 31, 2003, Energy Transfer transported approximately 30% of its natural gas volumes on the Oasis Pipeline pursuant to long-term contracts. Its long-term contracts have a term of one year or more. Energy Transfer also enters into short-term contracts with terms of less than one year in order to utilize the capacity that is available on the Oasis Pipeline after taking into account the capacity reserved under Energy Transfer's long-term contracts. For the 11 months ended August 31, 2003, the Oasis Pipeline accounted for approximately 57% of Energy Transfer's fee-based gross margin.

### Operating Expenses and Administrative Costs

Energy Transfer realizes significant economies of scale related to the Midstream segment as well as the Transportation segment. As additional volumes of natural gas move through Energy Transfer's systems, its incremental operating and administrative costs do not increase materially. Operating expenses are costs directly associated with the operations of a particular asset and include direct labor and supervision, property insurance, ad valorem taxes, repair and maintenance expenses, measurement and utilities. These costs are generally fixed across broad volume ranges. Energy Transfer's fuel expense to operate its pipelines and plants is more variable in nature and is sensitive to changes in volume and commodity prices.

### Effects of Changes in Commodity Price

Energy Transfer's profitability is affected by volatility in prevailing NGL and natural gas prices. Historically, changes in the prices of most NGL products have generally correlated with changes in the price of crude oil. NGL and natural gas prices have been subject to significant volatility in recent years in response to changes in the supply and demand for NGL products and natural gas market uncertainty. For a discussion of the volatility of natural gas and NGL prices, please read "Risk Factors -- Energy Transfer's profitability is dependent upon prices and market demand for natural gas and NGLs, which are beyond its control and have been volatile." The current mix of Energy Transfer's contractual arrangements described above together with its ability to bypass the processing plants significantly mitigates its exposure to the volatility of natural gas and NGL prices. Gas prices can also affect Energy Transfer's profitability indirectly by influencing drilling activity and related opportunities for natural gas gathering, compression, treating, processing, transportation and marketing.

### Significant Acquisitions

Energy Transfer acquired most of its assets in two strategic acquisitions. In October 2002, Energy Transfer acquired the Southeast Texas System, the Elk City System and a 50% equity interest in the Oasis Pipeline from Aquila Gas Pipeline, an affiliate of Aquila, Inc., for \$264 million in cash. In December 2002, Energy Transfer acquired the remaining 50% equity interest in the Oasis Pipeline from an affiliate of The Dow Chemical Company for \$87 million in cash.

Energy Transfer operates its assets differently than did Aquila Gas Pipeline. The differences in operations are as follows:

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- Aquila Gas Pipeline owned only a 50% equity interest in the Oasis Pipeline. As a result of Energy Transfer's 100% ownership of the Oasis Pipeline, it is able to achieve operating efficiencies that previously could not be achieved. These operating efficiencies include:
  - bypassing the La Grange processing plant when processing margins are unfavorable;
  - blending natural gas into the Oasis Pipeline instead of treating this natural gas; and
  - reducing general and administrative costs.
- Aquila Gas Pipeline had more extensive marketing and trading operations than Energy Transfer does primarily as a result of the marketing and trading of substantial amounts of off-system gas which utilized storage facilities owned by its affiliates. Unlike Aquila Gas Pipeline, Energy Transfer does not own storage facilities, and Energy Transfer focuses its marketing activities on its on-system

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gas. As a result of Energy Transfer's focus on marketing its on-system gas, its ability to bypass the La Grange processing plant and its efforts to manage commodity price risk by balancing its purchases of natural gas with physical forward contracts and certain financial derivatives, we believe that Energy Transfer's revenues, earnings and gross margins will be substantially less volatile than Aquila Gas Pipeline's historical results.

- In addition to the midstream business, Aquila, Inc. also participates in other areas of the energy industry including the regulated distribution of natural gas and electricity and non-regulated electric power generation. We believe that Energy Transfer's focus on midstream activities, as opposed to the diversified operations of Aquila Gas Pipeline's parent, will enable Energy Transfer to achieve additional operational efficiencies.

### RESULTS OF OPERATIONS OF ENERGY TRANSFER

Energy Transfer commenced operations on October 1, 2002 with the acquisition of the Southeast Texas System, the Elk City System and a 50% equity interest in Oasis Pipe Line Company from Aquila Gas Pipeline. On December 27, 2002, Energy Transfer acquired the remaining interest in Oasis Pipe Line. As a result, Energy Transfer's historical financial information for the period from October 1, 2002 to August 31, 2003, which is Energy Transfer's fiscal year end, has been derived from the historical financial statements of Energy Transfer.

Energy Transfer's historical financial information for periods prior to October 1, 2002 has been derived from the historical financial statements of Aquila Gas Pipeline. Prior to October 1, 2002, Aquila Gas Pipeline owned the Southeast Texas System, the Elk City System and a 50% equity interest in Oasis Pipe Line.

Therefore, we are comparing the results of operations of Energy Transfer for the 11 months ended August 31, 2003 to the results of operations of Aquila Gas Pipeline for the 9 months ended September 30, 2002.

Historical 11 Months Ended August 31, 2003 Compared to Historical 9 Months Ended September 30, 2002

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Revenues. Total revenues were \$1,008.7 million for the 11 months ended August 31, 2003 compared to \$933.1 million for the 9 months ended September 30, 2002, an increase of \$75.6 million or 8.1%. On an annualized basis this represents an 11.6% decrease.

Midstream revenues were \$978.1 million for the 11 months ended August 31, 2003 compared to \$933.1 million for the 9 months ended September 30, 2002, an increase of \$45.0 million or 4.8%. However, on an annualized basis this represents a 14.2% decrease. This annualized decrease was directly attributable to a reduction in natural gas and NGL daily sales volumes partially offset by higher natural gas and NGL sales prices.

Natural gas sales volumes were 524,000 MMBtu/d for the 11 months ended August 31, 2003 compared to 1,147,000 MMBtu/d for the 9 months ended September 30, 2002, a decrease of 623,000 MMBtu/d or 54.3%. NGL sales volumes were 12,857 Bbls/d for the 11 months ended August 31, 2003 compared to 18,881 Bbls/d for the 9 months ended September 30, 2002, a decrease of 6,024 Bbls/d or 31.9%. Natural gas sales volumes decreased significantly as a result of the smaller scope of Energy Transfer's marketing activities as compared to Aquila Gas Pipeline's extensive marketing and trading activities. NGL sales volumes decreased due to Energy Transfer's frequent election to bypass its La Grange processing plant and deliver unprocessed natural gas from its Southeast Texas System directly into the Oasis Pipeline during the portion of the 11 month period ended August 31, 2003 that it owned 100% of Oasis. Energy Transfer elected to bypass the La Grange processing plant to avoid unfavorable processing margins.

Average realized natural gas sales prices were \$5.03 per MMBtu for the 11 months ended August 31, 2003 compared to \$2.72 per MMBtu for the 9 months ended September 30, 2002, an increase of \$2.31 per MMBtu or 85.0%. In addition, average realized NGL sales prices were \$0.41 per gallon for the 11 months ended August 31, 2003 compared to \$0.32 per gallon for the 9 months ended September 30, 2002, an increase of \$0.09 per gallon or 26.8%.

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Transportation revenues were \$30.6 million for the 11 months ended August 31, 2003. Energy Transfer's results for the 9 month period ended September 30, 2002 and for the 3 month period ended December 27, 2002 exclude revenues of Oasis Pipe Line because Energy Transfer's investment in Oasis Pipe Line was treated as an equity method investment prior to December 27, 2002. Had Oasis Pipe Line been consolidated in both periods, Transportation revenues would have been \$38.6 million for the 11 months ended August 31, 2003 and \$24.7 million for the 9 months ended September 30, 2002, an increase of \$13.9 million or 56.3%. On an annualized basis this represents a 28.0% increase. This increase was due to an increase in volumes transported on the Oasis Pipeline from 912,584 MMBtu/d for the 9 months ended September 30, 2002 to 921,316 MMBtu/d for the 11 months ended August 31, 2003 and to an increase in the transportation rate on the Oasis Pipeline from \$0.09 per MMBtu for the 9 months ended September 30, 2002 to \$0.12 per MMBtu for the 11 months ended August 31, 2003. The increase in Energy Transfer's average transportation rate was achieved, in part, due to a widening of the difference, also known as the basis differential, between the average price for natural gas at the Katy Hub near Houston, Texas and the average price for natural gas at the Waha Hub in West Texas. The widening of the basis differential allows Energy Transfer to increase the transportation rates it charges between these points. The average basis differential for the 11 months ended August 31, 2003 was approximately \$0.28 per MMBtu as compared to \$0.11 per MMBtu for the 9 months ended September 30, 2002.

Cost of Sales. Total cost of sales was \$899.5 million for the 11 months ended August 31, 2003 compared to \$880.1 million for the 9 months ended

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September 30, 2002, an increase of \$19.4 million or 2.2%. On an annualized basis this represents a 16.4% decrease.

Midstream cost of sales was \$899.4 million for the 11 months ended August 31, 2003 compared to \$880.1 million for the 9 months ended September 30, 2002, an increase of \$19.3 million or 2.2%. However, on an annualized basis this represents a 16.4% decrease. This annualized decrease was primarily attributable to a reduction in volumes of natural gas and NGLs, partially offset by the increase in natural gas prices. The Transportation segment sold excess inventory during the 11 months ended August 31, 2003 resulting in a cost of sales of \$0.1 million. The Transportation segment only periodically engages in activities that generate cost of sales.

Operating Expenses. Operating expenses were \$19.1 million for the 11 months ended August 31, 2003 compared to \$12.7 million for the 9 months ended September 30, 2002, an increase of \$6.4 million or 50.0%. On an annualized basis this represents a 22.8% increase. This increase was due to the inclusion of approximately \$4.9 million of operating expenses associated with Oasis Pipe Line subsequent to December 27, 2002. Oasis Pipe Line's operating expenses were not included in Aquila Gas Pipeline's results for the 9 month period ended September 30, 2002, because Aquila Gas Pipeline accounted for its investment in Oasis Pipe Line under the equity method. Oasis Pipe Line's operating expenses on a standalone basis were \$4.7 million for the 9 months ended September 30, 2002 and \$6.6 million for the 11 months ended August 31, 2003.

General and Administrative Expenses. General and administrative expenses were \$16.0 million for the 11 months ended August 31, 2003 compared to \$9.6 million for the 9 months ended September 30, 2002, an increase of \$6.4 million or 66.7%. On an annualized basis this represents a 36.4% increase. This annualized increase resulted primarily from higher employee bonuses and increased travel and insurance costs as well as the inclusion of general and administrative expense of Oasis Pipe Line subsequent to December 27, 2002.

Depreciation and Amortization. Depreciation and amortization expense was \$13.4 million for the 11 months ended August 31, 2003 compared to \$22.9 million for the 9 months ended September 30, 2002, a decrease of \$9.5 million or 41.3%. On an annualized basis this represents a 51.9% decrease. Depreciation and amortization expense decreased for the 11 months ended August 31, 2003 primarily due to the acquisition of midstream assets from Aquila Gas Pipeline, which resulted in a reduction in the depreciable basis on which these assets are depreciated. Aquila Gas Pipeline's book value of the acquired assets significantly exceeded Energy Transfer's book value in them. In addition, Aquila Gas Pipeline amortized \$2.4 million during the 9 months ended September 30, 2002 related to a transportation rights contract that

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has expired. This decrease was partially offset by the inclusion of \$2.8 million of depreciation and amortization expense of Oasis Pipe Line subsequent to December 27, 2002.

Unrealized Loss (Gain) on Derivatives. The unrealized gain on derivatives was \$0.9 million for the 11 months ended August 31, 2003 compared to an unrealized loss of \$5.0 million for the 9 months ended September 30, 2002. Derivative price changes worked to the detriment of Aquila Gas Pipeline during the 9 months ended September 30, 2002.

Equity in Net Income (Loss) of Affiliates. Equity in net income of affiliates was \$1.4 million for the 11 months ended August 31, 2003 compared to \$5.4 million for the 9 months ended September 30, 2002, a decrease of \$4.0 million or 73.8%. This decrease resulted from equity in net income (loss) of

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affiliates for the 11 months ended August 31, 2003 not reflecting any equity earnings associated with Oasis Pipe Line subsequent to December 27, 2002 while Oasis Pipe Line's earnings were recognized under the equity method of accounting for the 3 months ended December 27, 2002 and the 9 months ended September 30, 2002. Equity earnings from Oasis Pipe Line included in total equity in net income (loss) of affiliates was \$1.6 million and \$5.4 million for the 3 months ended December 27, 2002 and 9 months ended September 30, 2002, respectively.

**Interest Expense.** Interest expense was \$12.1 million for the 11 months ended August 31, 2003 compared to \$3.9 million for the 9 months ended September 30, 2002, an increase of \$8.2 million or 210.3%. The increase was primarily due to the increased borrowings used to finance the purchase of midstream assets from Aquila Gas Pipeline and Dow Hydrocarbons Resources, Inc.

**Income Tax Expense.** Income tax expense was \$4.4 million for the 11 months ended August 31, 2003 compared to a benefit of \$0.5 million for the 9 months ended September 30, 2002. As a partnership, Energy Transfer is not subject to income taxes. However, Energy Transfer's subsidiary, Oasis Pipe Line, is a corporation that is subject to income taxes at an effective rate of 35%. The benefit for the 9 months ended September 30, 2002 was related to the operating results of Aquila Gas Pipeline, which is a corporation subject to income taxes.

**Net Income.** Energy Transfer's net income for the 11 months ended August 31, 2003 was \$46.6 million compared to \$4.7 million for the 9 months ended September 30, 2002, an increase of \$41.9 million. The increase in net income was due to the reasons described above.

### ENERGY TRANSFER LIQUIDITY AND CAPITAL RESOURCES

**ENERGY TRANSFER FUTURE CAPITAL REQUIREMENTS.** We anticipate that our future capital requirements for the Energy Transfer business will consist of:

- maintenance capital expenditures, which include capital expenditures made to connect additional wells to Energy Transfer's systems in order to maintain or increase throughput on existing assets;
- growth capital expenditures, mainly to expand and upgrade gathering systems, transportation capacity, processing plants or treating plants; and
- acquisition capital expenditures, including to construct new pipelines, processing plants and treating plants.

We believe that cash generated from the operations of the Energy Transfer business will be sufficient to meet its anticipated maintenance capital expenditures, which we anticipate will be approximately \$6 million during fiscal 2004. We will initially finance all of Energy Transfer's capital requirements by cash flow from the Energy Transfer business. To the extent Energy Transfer's future capital requirements exceed cash flows from the Energy Transfer business:

- Energy Transfer's maintenance capital expenditures will be financed by the proceeds of borrowings under the new Energy Transfer credit facility which will be repaid from subsequent cash flows generated from the Energy Transfer business;
- Energy Transfer's growth capital expenditures will be financed by the proceeds of borrowings under the new Energy Transfer credit facility; and
- Energy Transfer's acquisition capital expenditures will be financed by the proceeds of borrowings under the new Energy Transfer credit facility, other lines of credit, long-term debt, the issuance of additional common units or a combination thereof.

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The assets utilized in the Energy Transfer businesses, including pipelines, gathering systems and related facilities, are generally long-lived assets and do not require significant maintenance capital expenditures.

We anticipate that we will continue to invest significant amounts of capital to construct and acquire midstream assets. For example, Energy Transfer has announced that it intends to construct the Bossier

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Pipeline connecting its Katy Pipeline in Grimes County to natural gas supplies in east Texas. We anticipate that the Bossier Pipeline will require capital expenditures of approximately \$75 million to complete, and we expect to complete the Bossier Pipeline by mid-2004.

### ENERGY TRANSFER CASH FLOWS

**Operating Activities.** Energy Transfer's net cash provided by operating activities was \$70.9 million for the 11 months ended August 31, 2003. The net cash provided from operations consisted of net income of \$46.6 million and non-cash charges of \$15.8 million, primarily depreciation and amortization, and a decrease in working capital and certain long-term liabilities of \$8.9 million. Additionally, Energy Transfer's operating cash flow was negatively impacted by the difference between equity earnings and dividends from equity investments of \$0.4 million.

**Investing Activities.** Energy Transfer's net cash used in investing activities was \$341.2 million for the 11 months ended August 31, 2003. Approximately \$337.1 million (net of acquired cash through acquisitions) was invested by Energy Transfer for the acquisition of the midstream assets and the 50% interest in Oasis Pipe Line previously owned by Aquila Gas Pipeline and the purchase of the remaining 50% interest in Oasis Pipe Line previously owned by Dow Hydrocarbons Resources, Inc. During this period, Energy Transfer sold its 20% interest in the Nustar Joint Venture, which Energy Transfer determined was not a strategic asset. No gain or loss was recognized as a result of the sale. Energy Transfer's net proceeds from the sale of its interest in Nustar was \$9.6 million. Capital expenditures were \$13.9 million during the 11 months ended August 31, 2003.

**Financing Activities.** Energy Transfer's net cash used in financing activities was \$323.4 million for the 11 months ended August 31, 2003. Energy Transfer borrowed \$239.5 million, net of financing fees, for the purpose of financing the acquisition activity discussed above. Energy Transfer retired \$20.0 million of this debt during this same period and made a \$4.8 million distribution to its partners in April 2003. The partners contributed \$108.7 million to initially capitalize the partnership.

### ENERGY TRANSFER CONTRACTUAL OBLIGATIONS

The following table summarizes Energy Transfer's long-term debt and other contractual obligations as of August 31, 2003:

PAYMENTS DUE BY PERIOD				
TOTAL	LESS THAN 1 YEAR	1-3 YEARS	3-5 YEARS	MORE THAN 5 YEARS
(IN THOUSANDS)				

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Long term debt.....	\$226,000	\$30,000	\$196,000	\$--	\$ --
Operating lease obligations.....	2,244	920	1,323	1	--
	-----	-----	-----	---	---
Total.....	\$228,244	\$30,920	\$197,323	\$ 1	\$ --

The above table does not include any commodity physical contract commitments for natural gas or NGLs. Energy Transfer has forward commodity contracts, which will be settled by physical delivery. Short-term contracts, which expire in less than one year, require delivery of up to 54,000 MMBtu/d. Long-term contracts require delivery of up to 156,000 MMBtu/d. The long-term contracts run through July 2013.

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### ENERGY TRANSFER CRITICAL ACCOUNTING POLICIES

The following discussion summarizes Energy Transfer's critical accounting policies.

**Revenue Recognition.** Energy Transfer recognizes revenue for sales of natural gas and NGLs upon delivery. Service revenues, including transportation, compression, treating and gas processing, are recognized at the time service is performed. Transportation capacity payments are recognized when earned in the period the capacity was made available.

**Commodity Risk Management.** In 1999, Aquila Gas Pipeline transferred all of its trading operations to Aquila Energy Marketing, a wholly owned subsidiary of Aquila, Inc. Aquila Energy Marketing entered into forward physical contracts with third parties for the benefit of Aquila Gas Pipeline and where deemed necessary entered into intercompany financial derivative positions, such as swaps, futures and options, with Aquila Gas Pipeline and other affiliates to assist them in managing their exposures. As a result, Aquila Gas Pipeline had forward physical contracts with third parties and financial derivative positions with Aquila Energy Marketing and its affiliates. Aquila Gas Pipeline received the margins associated with these transactions, and Aquila Energy Marketing charged Aquila Gas Pipeline for its share of Aquila Energy Marketing's cost to manage Aquila Gas Pipeline's positions.

Aquila Gas Pipeline accounted for its derivative positions, both speculative forward positions and financial derivatives, under Emerging Issues Task Force Issue 98-10 "Accounting for Contracts Involved in Energy Trading and Risk Management Activities" ("EITF 98-10"). Under EITF 98-10, Aquila Gas Pipeline valued the derivative positions at market value with all changes being recognized in earnings. Realized gains and losses were included in revenues, while unrealized gains and losses were classified as such in the consolidated statements of income. Aquila Gas Pipeline's derivative positions were classified on its balance sheet as current or long-term price risk management assets and liabilities based on their maturity. Although Energy Transfer is also involved in energy marketing activities and use derivatives to manage its exposures, Energy Transfer did not purchase the derivative positions of Aquila Gas Pipeline when it purchased the assets of Aquila Gas Pipeline.

Effective in the fourth quarter of 2002, the Emerging Issues Task Force issued Issue 02-03, which rescinded EITF 98-10. As a result all energy trading derivative transactions are now governed by Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities ("SFAS No. 133"). SFAS No. 133 as amended by Statement of Financial Accounting Standards No. 138, Accounting for Certain Derivative Activities and Certain Hedging Activities ("SFAS 138"), requires that every derivative instrument (including certain derivative instruments embedded in other contracts) be

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recorded in the balance sheet as either an asset or liability measured at its fair market value. The statements require that changes in the derivative's fair value be recognized currently in earnings unless specific hedge criteria are met. Special accounting for qualifying hedges allows a derivative's gain and loss to offset related results on the hedged item in the income statement and requires that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting.

Energy Transfer utilizes various exchange-traded and over-the-counter commodity financial instrument contracts to limit its exposure to margin fluctuations in natural gas and NGL prices. These contracts consist primarily of futures and swaps. As its financial derivative positions are typically short-term positions, Energy Transfer has generally elected not to designate them as hedges under SFAS No. 133, although Energy Transfer believes some of them would qualify as hedges if they were designated as such. As a result, the net gain or loss arising from marking to market these positions is recognized currently in earnings.

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In the course of normal operations, Energy Transfer also routinely enters into forward physical contracts for the purchase and sale of natural gas and NGLs along various points of its systems. These positions require physical delivery and are treated as normal purchases and sales contracts under SFAS No. 133. Accordingly, unlike Aquila Gas Pipeline under EITF 98-10, under EITF 02-03 and SFAS No. 133, Energy Transfer does not mark these contracts to market on its financial statements. They are accounted for at the time of delivery.

The market prices used to value forward physical contracts and financial derivatives at Aquila Gas Pipeline and financial derivatives at Energy Transfer reflect management's estimates considering various factors, including closing exchange and over-the-counter quotations and the time value of the underlying commitments. The values have been adjusted to reflect the potential impact of liquidating a position in an orderly manner over a reasonable period of time under existing market conditions.

Property, Plant and Equipment. Pipeline, property, plant, and equipment are stated at cost. Maintenance capital expenditures are capital expenditures made to replace partially or fully depreciated assets in order to maintain the existing operating capacity of Energy Transfer's assets and to extend their useful lives. Maintenance capital expenditures also include capital expenditures made to connect additional wells to Energy Transfer's systems in order to maintain or increase throughput on its existing assets. Expansion capital expenditures are capital expenditures made to expand the existing operating capacity of its assets, whether through construction or acquisition. Energy Transfer treats repair and maintenance expenditures that do not extend the useful life of existing assets as operating expenses as Energy Transfer incurs them. Upon disposition or retirement of pipeline components or gas plant components, any gain or loss is recorded to accumulated depreciation. When entire pipeline systems, gas plants or other property and equipment are retired or sold, any gain or loss is included in operations.

Depreciation of the pipeline systems, gas plants and processing equipment is provided using the straight-line method based on an estimated useful life of primarily twenty years. The Oasis Pipeline is depreciated based on an estimated useful life of sixty-five years.

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