

## RATING METHODOLOGY Global Midstream Energy

### Table of Contents:

SUMMARY	1
ABOUT THE RATED UNIVERSE	2
ABOUT THIS RATING METHODOLOGY	4
THE KEY FACTORS FOR THE GRID	6
CONCLUSION: SUMMARY OF THE GRID-INDICATED RATING OUTCOMES	18
APPENDIX A: MIDSTREAM ENERGY INDUSTRY FACTOR GRID	19
APPENDIX B: GRID-INDICATED RATINGS	20
APPENDIX C: OBSERVATIONS AND OUTLIERS FOR GRID MAPPING	21
APPENDIX D: MIDSTREAM ENERGY INDUSTRY OVERVIEW	24
APPENDIX E: KEY RATING ISSUES OVER THE INTERMEDIATE TERM	25

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### Summary

This rating methodology explains Moody's approach to assessing credit risk for midstream energy companies. This publication is intended to provide a reference tool that can be used when evaluating credit profiles within the midstream energy industry, helping issuers, investors, and other interested market participants understand how key qualitative and quantitative risk characteristics are likely to affect rating outcomes. This methodology does not include an exhaustive treatment of all factors that are reflected in Moody's ratings but should enable the reader to understand the qualitative considerations and financial ratios that are most important for ratings in this sector.

This report includes a detailed rating grid and illustrative mapping of a representative sample of 12 rated companies against the factors in the grid. The purpose of the rating grid is to provide a reference tool that can be used to approximate credit profiles within the midstream energy sector. The grid provides summarized guidance for the factors that are generally most important in assigning ratings to midstream companies. However, the grid is a summary that does not include every rating consideration, and our illustrative mapping uses historical results while our ratings also consider forward-looking expectations. As a result, the grid-indicated rating is not expected to match the actual rating of each company.

The grid contains three key factors that are important in our assessments for ratings in the midstream energy sector:

1. Scale
2. Business Risk
3. Financial Leverage & Distribution Profile

Each of these factors also encompasses a number of sub-factors or metrics, which we explain in detail. Since an issuer's scoring on a particular grid factor often will not match its overall rating, in the Appendix we include a discussion of "outliers" – companies whose grid-indicated rating for a specific factor differs significantly from the actual rating.

This rating methodology is not intended to be an exhaustive discussion of all factors that Moody's analysts consider for assigning ratings in this sector. We note that our analysis for ratings in this sector covers factors that are common across all industries (such as ownership, management, liquidity, legal structure in the corporate organization, and corporate governance) as well as factors that can be meaningful on a company specific basis. Our ratings consider qualitative considerations and factors that do not lend themselves to a transparent presentation in a grid format. The grid represents a compromise between greater complexity that would result in grid-indicated ratings that map more closely to actual ratings, and simplicity that enhances a transparent presentation of the factors that are usually most important for ratings in this sector.

Highlights of this report include:

- » An overview of the rated universe
- » A description of the key factors that drive rating quality
- » Comments on the rating methodology's assumptions and limitations, including a discussion of rating considerations that are not included in the grid.

The Appendices show the rating grid criteria on one page (Appendix A), tables that illustrate the application of the methodology grid to 12 representative rated midstream companies (Appendix B) with explanatory comments on some of the more significant differences between the grid-implied rating and our actual rating (Appendix C), a brief industry overview (Appendix D), and a discussion of key rating issues for the midstream sector over the intermediate term (Appendix E).

## About the Rated Universe

Moody's rates 48 companies in the midstream industry. In the aggregate, these issuers have approximately \$84 billion of rated debt. Midstream companies own assets involved in some aspect of the delivery of crude oil and natural gas products from the wellhead to market. Midstream companies handle crude oil, petroleum products, natural gas and natural gas liquids in various types of gathering, treating, transportation and storage and terminaling facilities. The midstream universe excludes other aspects of the energy business that are covered in other published rating methodologies, such as upstream oil and gas exploration and production (E&P), the refining and marketing of those hydrocarbon products, and the delivery of natural gas to end-users on a rate-regulated basis.

Rated midstream issuers are primarily based in the U.S., with a handful headquartered in Canada and the Caribbean. The peer group includes publicly and privately owned corporations (C-Corps), as well as partnerships - master limited partnerships (MLPs) and limited liability companies (LLCs). The midstream assets' critical role in the energy market qualifies them under the U.S. Federal Tax Code to be owned by MLPs. MLPs have become the dominant type of corporate organization in the midstream sector, and this has had credit implications for a company's strategy and financial policy.

The Corporate Family Rating (CFR) or senior unsecured ratings of the covered issuers range from A2 to B3 with a concentration in the Baa2 and Ba3 rating categories. The median rating for the midstream companies is Ba1. As of the date of publication, approximately 85% of the issuers had stable outlooks, while 8% had negative outlooks (which includes one review for possible downgrade) and 2% had positive outlooks.

## EXHIBIT 1

**Global Midstream Rating Methodology Universe**

Company	Rating (1)	Outlook	Rated Debt (MM US\$)
Colonial Pipeline Company	A2	Stable	\$1,574
LOCAP LLC	Prime-2 (2)	Stable	\$20
LOOP LLC	A3	Stable	\$251
Enbridge Energy Limited Partnership	Baa1	Stable	\$300
Explorer Pipeline Company	Prime-2 (3)	Stable	\$0
National Fuel Gas Company	Baa1	Stable	\$1,399
National Gas Company of Trinidad & Tobago	Baa1	RUR - Down	\$400
Phoenix Park Gas Processors Limited	Baa1	Stable	\$375
Buckeye Partners, L.P.	Baa2	Stable	\$1,425
DCP Midstream, LLC	Baa2	Stable	\$2,852
Enbridge Energy Partners, L.P.	Baa2	Stable	\$3,600
Enbridge Income Fund	Baa2	Stable	\$290
Kinder Morgan Energy Partners, L.P.	Baa2	Negative	\$11,644
Magellan Midstream Partners, L.P.	Baa2	Stable	\$1,850
ONEOK Partners, L.P.	Baa2	Stable	\$2,725
ONEOK, Inc.	Baa2	Stable	\$1,711
Sunoco Logistics Partners L.P.	Baa2	Stable	\$925
Energy Transfer Partners, L.P.	Baa3	Stable	\$5,050
Enogex LLC	Baa3	Stable	\$450
Enterprise Products Partners L.P.	Baa3	Stable	\$11,997
NuStar Energy L.P.	Baa3	Stable	\$400
Plains All American Pipeline L.P.	Baa3	Stable	\$4,375
Williams Partners LP	Baa3	Stable	\$4,850
El Paso Pipeline Partners, L.P.	Ba1	Stable	\$535
Energy Transfer Equity, L.P.	Ba1	Negative	\$2,000
Enterprise GP Holdings L.P.	Ba1	Stable	\$1,175
Kinder Morgan Inc.	Ba1	Negative	\$5,060
Vulcan Energy Corporation	Ba1	Stable	\$285
AmeriGas Partners, L.P.	Ba2	Stable	\$765
Inergy, L.P.	Ba2	Stable	\$1,650
Suburban Propane Partners, L.P.	Ba2	Stable	\$250
Copano Energy, LLC	Ba3	Negative	\$605
Ferrellgas Partners L.P.	Ba3	Stable	\$1,080
Holly Energy Partners, L.P.	Ba3	Stable	\$335
MarkWest Energy Partners, L.P.	Ba3	Stable	\$1,650
Niska Gas Storage	Ba3	Stable	\$2,638
Penn Virginia Resource Partners, L.P.	Ba3	Stable	\$300
Regency Energy Partners LP	Ba3	Positive	\$1,208

## EXHIBIT 1

## Global Midstream Rating Methodology Universe

Company	Rating (1)	Outlook	Rated Debt (MM US\$)
Targa Resources Partners LP	Ba3	Stable	\$709
Gibson Energy Holdings ULC	B1	Stable	\$760
Martin Midstream Partners L.P.	B1	Stable	\$200
SG Resources Mississippi L.L.C.	B1	Stable	\$587
Star Gas Partners, L.P.	B1	Stable	\$125
Targa Resources, Inc.	B1	Stable	\$1,197
Crosstex Energy, L.P.	B2	Stable	\$725
First Reserve Crestwood Holdings LLC	B2	Stable	\$180
High Sierra Energy, LP	B2	Stable	\$150
Atlas Pipeline Partners, L.P.	B2	Positive	\$880

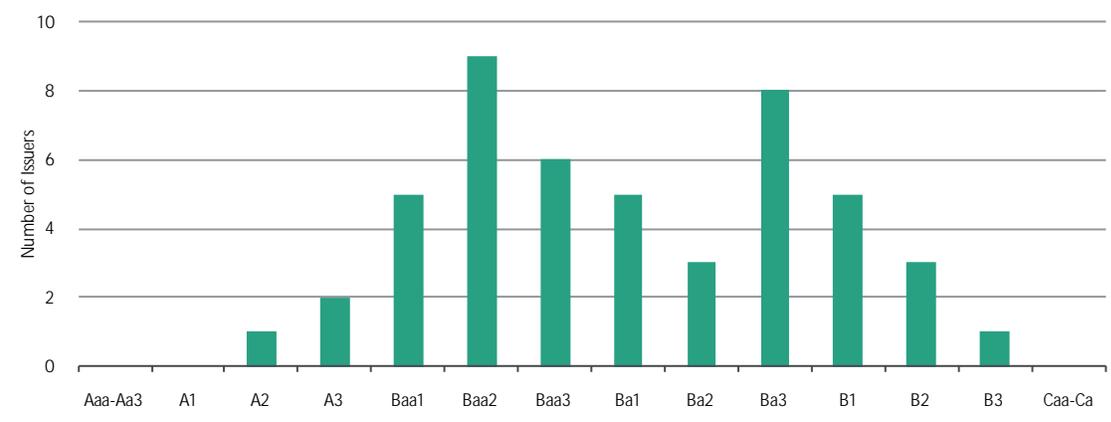
(1) Senior unsecured rating for investment grade companies, Corporate Family Rating for non-investment grade companies

(2) LOCAP does not have a long-term debt rating. The company has a Prime-2 short-term rating for commercial paper.

(3) Explorer does not have a long-term debt rating. The company has a Prime-2 short-term rating for commercial paper.

## EXHIBIT 2

## Global Midstream Rating Distribution



## About this Rating Methodology

This report explains the rating methodology for midstream energy companies in six sections, which are summarized as follows:

### 1. Identification of Key Factors for the Grid

The grid in this rating methodology focuses on three rating factors. The three factors are further broken down into six sub-factors.

Rating Factor	Factor Weighting	Relevant Sub-Factor	Sub-Factor Weighting
Scale	30%	Property, Plant & Equipment, net (PP&E)	15%
		EBITDA	15%
Business Risk	30%	Estimated Price & Volume Risk Exposure	30%
		EBITDA / Interest Expense	15%
Financial Leverage & Distribution Profile	40%	Debt / EBITDA	15%
		(FFO - Maintenance CAPEX) / Distributions	10%

## 2. Measurement or Estimation of the Key Factors in the Grid

We explain below how the sub-factors for each factor are calculated and the weighting for each individual sub-factor. We also explain the rationale for using specific rating metrics, and the ways in which we apply them during the rating process. Much of the information used in assessing performance for the sub-factors is found in or calculated using the company's financial statements; others are derived from observations or estimates by Moody's analysts.

Moody's ratings are forward-looking and incorporate our expectations for future financial and operating performance. We use both historical and projected financial results in the rating process. Historical results help us understand patterns and trends for a company's performance as well as for peer comparisons. While the rating process includes both historical and anticipated results, this document makes use of historical data only to illustrate the application of the rating grid. Specifically, the mapping examples use reported financials for the one-year period ending June 30, 2010. All of the quantitative credit metrics incorporate Moody's standard adjustments to financial statements.

## 3. Mapping Factors to the Rating Categories

After calculating or estimating the value for each grid factor, the potential outcomes for each of the 6 sub-factors are mapped to a broad Moody's rating category (Aaa, Aa, A, Baa, Ba, B, Caa).

## 4. Mapping Issuers to the Grid and Discussion of Grid Outliers

In this section (Appendix B) we provide tables showing how 12 representative companies map to grid-indicated ratings for each rating sub-factor. The weighted average of the sub-factor ratings produces a grid-indicated rating for each factor. We highlight companies whose grid-indicated performance on a specific sub-factor is two or more broad rating categories higher or lower than its actual rating and discuss general reasons for such positive outliers and negative outliers for a particular factor or sub-factor.

## 5. Assumptions and Limitations and Rating Considerations That are not Included in the Grid

This section discusses limitations in the use of the grid to map against actual ratings, additional factors that are not included in the grid that can be important in determining ratings, and limitations and key assumptions that pertain to the overall rating methodology.

## 6. Determining the Overall Grid-Indicated Rating

To determine the overall grid-indicated rating, we convert each of the 6 sub-factor ratings into a numeric value based upon the scale below.

Aaa	Aa	A	Baa	Ba	B	Caa
1	3	6	9	12	15	18

The numerical score for each sub-factor is multiplied by the weight for that sub-factor with the results then summed to produce a composite weighted factor score. The composite weighted factor score is then mapped back to an alphanumeric rating based on the ranges in the table below.

Grid-Indicated Rating	Aggregate Weighted Total Factor Score
Aaa	$x < 1.5$
Aa1	$1.5 \leq x < 2.5$
Aa2	$2.5 \leq x < 3.5$
Aa3	$3.5 \leq x < 4.5$
A1	$4.5 \leq x < 5.5$
A2	$5.5 \leq x < 6.5$
A3	$6.5 \leq x < 7.5$
Baa1	$7.5 \leq x < 8.5$
Baa2	$8.5 \leq x < 9.5$
Baa3	$9.5 \leq x < 10.5$
Ba1	$10.5 \leq x < 11.5$
Ba2	$11.5 \leq x < 12.5$
Ba3	$12.5 \leq x < 13.5$
B1	$13.5 \leq x < 14.5$
B2	$14.5 \leq x < 15.5$
B3	$15.5 \leq x < 16.5$
Caa1	$16.5 \leq x < 17.5$
Caa2	$17.5 \leq x < 18.0$

For example, an issuer with a composite weighted factor score of 11.7 would have a Ba2 grid-indicated rating. We used a similar procedure to derive the grid-indicating ratings in the tables embedded in the discussion of each of the three broad rating factors.

### The Key Factors for the Grid

Moody's analysis of midstream energy companies considers three broad factors that are represented in the grid:

- » Scale
- » Business Risk
- » Financial Leverage & Distribution Profile

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## Factor 1: Scale (30% weight)

### Why It Matters

This factor includes measures that attempt to assess the size and diversity of a business model. Bigger companies tend to be more highly rated as they benefit from greater financial resources, liquidity and economies of scale. Larger companies are generally more broadly diversified, both by business line and geographically, which can reduce volatility and lower credit risk. Larger companies typically have demonstrated greater durability through multiple cycles over time. Larger size also tends to facilitate access to the capital markets through various points in the cycle.

Larger scale, as defined by PP&E and EBITDA, helps to better absorb risks to a midstream company's operations or financial performance. A larger scale implies a platform for sustainable earnings and cash flows and can also have a positive effect on a company's relative market position. Economies of scale could be derived from wider spreading of resources and cheaper supply procurement. A diverse spread of midstream assets can have a positive portfolio benefit for a midstream company's ratings, as risk profiles and supply and demand dynamics can vary by business line and geographic region. Moreover, a large, integrated midstream network enables operational flexibility, with the ability to access several supply and delivery points economically, and can also provide competitive advantages.

Larger scale, in terms of PP&E, is an indication of the degree of hard asset coverage of long term debt. We believe PP&E is a better indicator of long term debt coverage than total assets, which can be inflated by significant working capital assets, such as from marketing operations, including back-to-back buy/sell arrangements, or from significant intangible assets, such as goodwill.

Exceptions to the generalization about the advantages of greater size are certain facilities that hold unique, critical positions in supplying some regions. Their facilities and services could be hard to replicate, and consequently, could result in supply disruptions or companies operating at high utilization rates. For those companies that are modest in size, but which have strong credit qualities due to a dominant position in a market that is small but protected by structural or operational barriers to entry, alternative lower levels of PP&E and EBITDA could be applied in the A and Baa rating categories.

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## How We Measure or Estimate It for the Grid

### Property, Plant & Equipment, net (PP&E)

The unit of measurement is generally the most recent financial disclosure on net PP&E. PP&E is relatively stable over time, absent major expansions, acquisitions or an impairment writedown. For companies that have made significant acquisitions, pro forma PP&E may be used.

### EBITDA

The unit of measurement is the last twelve months' EBITDA. Historical data are less meaningful for many companies in the peer group that are recently formed, have made acquisitions that altered their credit profiles or when recent results reflect a period of significant industry strength or weakness that is not likely to recur over the near to medium term. In these cases, a rating committee may use pro forma EBITDA or rely more heavily upon our expectations for future performance to best reflect an evolving credit situation.

## Factor 1: Scale (30%)

	Aaa	Aa	A	Baa	Ba	B	Caa
PP&E (US\$ MM)	≥ \$25,000	\$10,000 < \$25,000	\$5,000 < \$10,000 or \$2,500 < \$5,000 w/dominant position in protected market	\$2,500 < \$5,000 or \$1,000 < \$2,500 w/dominant position in protected market	\$1,000 < \$2,500	\$300 < \$1,000	< \$300
EBITDA (US\$ MM)	≥ \$5,000	\$2,000 < \$5,000	\$1,000 < \$2,000 or \$500 < \$1,000 w/dominant position in protected market	\$500 < \$1,000 or \$200 < \$500 w/dominant position in protected market	\$200 < \$500	\$50 < \$200	< \$50

A chart that illustrates grid mapping results for Factor 1 and a discussion of outliers is included in Appendix C.

## Factor 2: Business Risk (30% weight)

### Why It Matters

A primary differentiating factor in the credit ratings of midstream companies is the business risk profile of their asset portfolios. The different types of businesses that make up the midstream sector entail different degrees of business risk. Furthermore, within the same business activity, business risk can and often does differ. As such, the business risk of any individual midstream company can vary greatly, and consequently, the degree of cash flow volatility and debt capacity.

Compared to the broader peer group of non-financial corporates, midstream companies tend to own assets with less business risk, generally operating stable and long-lived assets that have low reinvestment needs. However, as the midstream sector has continued to mature, there has been a dearth of higher-quality, lower risk assets, such as refined product pipelines. As a result, many midstream companies have expanded into business lines that entail relatively higher exposure to commodity price and volume risk (for example, expanding into gas gathering and processing and marketing and trading or moving into non-traditional assets, such as refining, in order to grow).

### How We Estimate it for the Grid

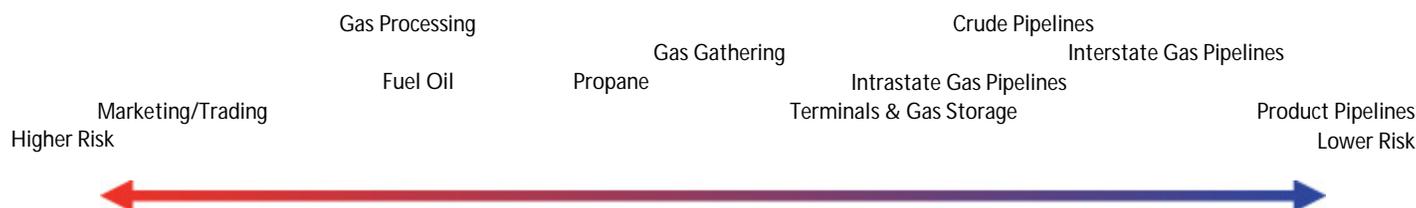
#### Estimated Price and Volume Risk Exposure

This factor is based on analyst judgment and a forward looking view with respect to a company's exposure to commodity price and volume risk. Our starting point is breaking down estimated earnings or cash flows by business line and determining the relative risk level as well as the scale of these activities. Segment data in public data can be a helpful starting point; however, the classification of business types is not always consistent within the peer group and there can be large variations in business risk between assets within the same business line. Furthermore, a sum-of-the-parts approach often does not tell the entire story, as even a modest amount of exposure to higher risk businesses, such as marketing and trading, can significantly raise the overall risk profile of an enterprise. As such, our approach is ultimately a qualitative assessment based on our view of a company's future strategic direction and underlying price and volume trends.

As shown in the chart below, there are several key midstream businesses that can present varying degrees of business risk. Below we provide a brief description of each of the key midstream segments,

as described in order from the generally lowest risk to the generally highest risk midstream businesses. This list does not encompass all midstream activities but accounts for the primary midstream business activities.

### The Midstream Risk Spectrum



**Petroleum product pipelines:** Petroleum product pipelines are generally the most stable of pipeline types, and hence have lowest risk in the business risk spectrum. Unlike the crude oil and natural gas pipelines, their volumes tend to be fairly steady, since they are not connected to depleting assets. High barriers to entry to building new capacity limit competition and promote volume stability. However, a pipeline's business risk could be increased somewhat if it faces competition from other pipelines, a local refinery, barge, or rail transportation or if it faces long-term demand destruction from high product prices or secular changes in consumption patterns. For instance, Moody's believes long-term growth in gasoline demand in North America is limited due to increasing fuel efficiency standards and rising bio fuels consumption. Petroleum product pipelines are subject to relatively light-handed regulation and are generally less prone to regulatory risk than gas pipelines. In the U.S., product pipelines rates are either market-based or indexed, the latter which is re-set annually based on the Producers Price Index for finished goods.

**Interstate gas pipelines:** Interstate gas pipelines are generally considered riskier than product pipelines, because they are connected to gas reserves that decline over time. Still, they are low risk, being regulated and drawing most of their revenues from volume-insensitive demand charges under long-term contracts. On the other hand, they are more exposed than petroleum product and crude oil pipelines to regulatory risk if they undergo a rate case, which is infrequent. Their business risk could be raised somewhat if they face competition against other pipelines that result in discounting of rates or re-contracting risk. In the U.S., interstate pipelines' rates are regulated federally by the Federal Energy Regulatory Commission (FERC), and rates have traditionally been based on the cost of service. In Canada, the National Energy Board (NEB) has jurisdiction over inter-provincial pipelines and sets rates based on cost of service.<sup>1</sup>

**Crude oil pipelines:** Where crude oil production is generally more mature than gas production, such as North America, crude oil pipeline volumes tend to be more at risk. The reverse may be true in some other global markets or in emerging oil plays in North America. Marketing activity commonly comprises a more significant portion of crude oil pipelines' revenues than for petroleum product and interstate gas pipelines. Marketing usually entails a back-to-back transaction, whereby oil is bought and sold simultaneously at a discount at a pricing point, with that discount being the pipeline's fee. In the U.S., crude oil pipelines rates are either market-

<sup>1</sup> Please refer to Moody's Rating Methodology North American [Natural Gas Pipelines](#), December 2009, in particular, Appendix E, which discusses recent changes in the NEB's approach to establishing deemed capital structures and allowed returns on equity for purposes of setting rates.

based or indexed. Indexed rates are adjusted annually based on the Producers Price Index for finished goods but can periodically reset based on a cost of service rate case at FERC. In Canada, crude oil pipelines are regulated on a cost of service basis by the NEB although it is common for pipelines and shippers to enter into multi-year negotiated settlements or even long-term contractual arrangements. Both negotiated settlements and long-term contracts are subject to NEB approval.

**Intrastate gas pipelines:** State or sub-sovereign regulated pipelines, such as intrastate gas pipelines in the U.S., are considered riskier than nationally regulated or interstate gas pipelines. Compared to interstate gas pipelines, generally, their revenues are more sensitive to market conditions, particularly basis differentials, with rates that are negotiated with their shippers on shorter term contracts and marketing activity similar to that described above for crude oil pipelines. In the U.S. and Canada, intrastate and intra-provincial pipelines are subject to regulation at the state or provincial level, which can be more light-handed than national regulation.

**Terminals & natural gas storage:** Terminaling and natural gas storage tends to be a small, ancillary business to the core pipeline business. This business is assessed on the degree of its sensitivity to volumes, commodity prices, weather, and other market conditions. Contract terms often vary from short to medium term. Volumes could be steady if local competition is limited.

**Gas gathering & processing:** G&P can be a volatile business subject to varying degrees of commodity price risk and volume (throughput) risk. The potential for cash flow volatility is generally proportional to the level of gas processing activity and its exposure to commodity price risk.

We consider gas processing to be the riskier component of G&P because processors are exposed not only to volume risk but typically to direct commodity price risk as well. The different types of processing contract structures (fee-based, percentage of proceeds and keep-whole) subject the processor to varying degrees commodity price risk. We generally consider keep-whole contracts, in which the processor retains the NGLs removed from the gas stream and is obligated to replace them with gas of an identical energy value, to entail the greatest degree of commodity price risk. When frac spreads are negative, the processor will effectively have to pay the shipper for the privilege of processing the shipper's gas under a keep-whole structure (although we note that many keep-whole contracts have been restructured over the last several years to protect against negative frac spreads). Percentage of proceeds contracts also expose processors to commodity price risk in that all or a portion of their compensation is linked to the value of gas and/or liquids processed. We consider fee-based contracts to be the least risky form of contract as the processor takes limited or no commodity price risk and is compensated on the basis of volumes processed. Regardless of contract structure, gas processors are exposed to indirect commodity price exposure because processing volumes are very sensitive to prices for natural gas liquids and natural gas (i.e., when frac spreads are low, producers are inclined to minimize the percentage of their production that is processed provided that they can continue to comply with pipeline specs).

Gas gathering is the less risky component of G&P since the business is predominantly fee-based. However, gas gathering is exposed to throughput risk and requires a degree of ongoing capital expenditures for additional well connects. Furthermore, gathering systems are usually integrated with the riskier processing function and therefore can be exposed to varying degrees of commodity price risk.

We would view a G&P operation more favorably if it has established a competitive position in a long-lived or growing basin and has a predominance of fee-based contracts. We also view favorably a lack of keep-whole processing contracts or keep-whole processing contracts with terms that mitigate negative frac spread exposure. We view less favorably small G&P operations in which production is declining, competition is high and keep-whole exposure is significant.

**Propane & fuel oil:** Propane and fuel oil retailing are seasonal businesses that typically post earnings during the winter heating season and losses during the summer. Financial performance is driven by the severity of winter weather. Propane derives a measure of stability from serving a utility-like function in the ex-urban and rural communities they serve. Residential customers typically lease a propane tank, and customer retention is generally promoted by state laws that prohibit another retailer from filling that tank. The fuel oil business is more competitive, and customer churn could be significant. Geographic diversity could help to reduce sensitivity to weather or economic conditions in any one market.

**Energy marketing:** Marketing is on the high end of the risk spectrum due to the volatility of its cash flows, the need for strong risk management and internal controls and the potentially significant use of working capital. Thus, it is considered least compatible with supporting long term debt. Volumes are difficult to predict, driven by commodity prices, weather, and other market conditions. The high payouts of many midstream companies leave little financial capacity to engage in marketing, although this function is ancillary to pipeline, G&P, and terminaling and natural gas storage businesses. The credit quality of the counterparties, the company's track record, risk management capability and liquidity resources are considered to gauge relative risk.

It is important to note that within the same business activity, business risk can and often does vary. Factors that could differentiate the degree of price and volume exposure include varying degrees of supply and demand fundamentals, the quality of contracts, strength and diversity of customers, the significance of market-driven revenues, geographic diversity, competition and regulatory risk.

Additionally, our assessment of a midstream company's business risk incorporates its entire operations. A number of companies in the peer group are engaged in peripheral midstream businesses, such as marine transportation, or businesses outside of the midstream sector, such as refining or exploration and production. In cases where a company has a large presence in another business line that is covered by a published rating methodology, we may consider using a sum-of-the-parts analysis.

*A note on hedging*

Most companies in the midstream peer group with exposure to commodity prices utilize hedges to help mitigate their direct exposure to volatile and cyclical commodity prices. Moody's generally believes hedging to be a conservative practice, and it can often provide near-term liquidity support for companies, particularly for those rated non-investment grade. However, it is often difficult and costly to hedge effectively for a meaningful period of time in the midstream sector and is unlikely to boost a company's rating.

Hedging is often necessary in the sector given the high payouts and exposure to commodity price risk. Hedging can also introduce new risks, such as increased liquidity needs and execution risks, and requires strong internal controls. As such, when assessing exposure to commodity price risk, we generally look to understand the underlying price risk exposure, both direct and indirect. We would note that we do consider hedging policies when assessing a company's financial strategy. Additionally, we give full benefit for the impact from realized hedging gains and losses in our EBITDA and cash flow metrics.

**Factor 2: Business Risk (30%)**

	Aaa	Aa	A	Baa	Ba	B	Caa
Estimated Price & Volume Risk Exposure	Expected to have nil medium to long term volume risk, no direct commodity price risk, strong commercial outlook and/or protected market, high proportion of long term contracts with highly rated counterparties	Expected to have modest long-term volume risk but no medium term risk, no direct commodity price risk, strong commercial outlook and/or protected market, high proportion of medium and long term contracts with highly rated counterparties	Expected to have limited medium term volume risk, no direct commodity price risk, strong commercial outlook and/or protected market, high proportion of medium term contracts with highly rated counterparties	Expected to have modest near to medium term volume risk, limited direct commodity price risk, strong commercial outlook	Expected to have significant volume risk, modest direct commodity price risk	Expected to have substantial volume risk, direct commodity price risk	Expected to have very high price and volume risk, primarily of a speculative nature

A chart that illustrates grid mapping results for Factor 2 and a discussion of outliers is included in Appendix C.

**Factor 3: Financial Leverage & Distribution Profile (40% weight)***Why It Matters*

Financial leverage and distribution profile are a function of both a company's financial performance and its financial policies, including its philosophy regarding capital structure and the degree of financial risk under which it is willing to operate. Financial leverage and distribution profile can provide an indication as to how well a company might cope through periods of industry weakness, its capacity to incur additional debt and its balance sheet flexibility. Financial flexibility is crucial for midstream MLPs due to their heavy reliance on the capital markets.

Because midstream companies' generally exhibit high distributions that cause book equity to erode over time, coverage measures are more useful than capitalization measures in assessing their ability to service their debt obligations. We look at three ratios: 1) interest coverage (EBITDA / Interest), 2) leverage (Debt / EBITDA) and 3) distribution coverage (FFO - Maintenance Capex / Distributions). We believe that the amount of leverage with which management operates and its dividend payout profile are choices and a direct result of its financial strategy. Midstream issuers actively manage to these ratios. In addition, these ratios are often used by providers of capital in the form of specific covenant tests.

With most of the midstream peer group comprised of MLPs, midstream companies' financial policies consider the interests of their yield-oriented equity holder base. Moody's considers publicly-traded partnerships' distributions to be, in effect, a fixed cash requirement and their dividend policy as indicative of management's financial policies overall. Although not subject to public unitholder pressures, privately-owned midstream companies frequently also have high payouts because of the free cash flow they generate and the cash requirements of their owners.

Since the midstream sector's business profile has historically exhibited less risk than the broader peer group of non-financial corporates, the sector's financial leverage and payout profile are generally higher than other rated industrial companies. However, as we have seen business risk increasing in the midstream space, we have also seen financial risk increase. Many companies debt funded organic expansions and fell behind on equity issuance during the financial crisis of 2009. Lowering leverage as a midstream MLP is challenging and often only achieved through earnings growth, as opposed to debt reduction.

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### How We Measure or Estimate it for the Grid

The period of measurement is one year. Historical figures are less meaningful for many companies in the peer group that are recently formed, have made acquisitions that altered their credit profiles or when recent results reflect a period of significant industry strength or weakness that is not likely to reoccur over the near to medium term. In these cases, a rating committee might use pro forma ratios or rely more heavily upon our expectations for future performance to best reflect an evolving credit situation.

Moody's adjusts a midstream company's financial statements per Moody's standard adjustments, including off-balance sheet items such as operating leases, unfunded pension liabilities, securitizations, and the debt component of hybrid securities. We also adjust the financial statements to account for extraordinary or non-recurring items, realized gains and losses related to hedging activity, and earnings and debt obligations for unconsolidated entities, such as joint ventures. For companies with debt at a holding company or in the case of a MLP, at the General Partner (GP), we assess the issuer both on a standalone basis as well as on a consolidated family level, including the debt of the holding company or GP if it primarily relies on distributions from the issuer to service its debt and pay its own distributions. For issuers with material marketing or trading operations, we consider leverage based on a fully consolidated basis and also excluding both the earnings and short term debt balances associated with the marketing and trading operations, as we generally view these operations as having very limited long term debt capacity.

### EBITDA / Interest Expense

Interest coverage can be particularly meaningful for speculative grade companies. This is especially true if the interest rate environment is in a period of change, such as the migration from lower rates to

higher rates, and an issuer is facing the need to refinance debt that is nearing maturity. Interest coverage is a key element of default probability.

#### Debt / EBITDA

Debt / EBITDA is a measure of a company's ability to cover debt with a proxy level of cash flow, as indicated by EBITDA. Debt / EBITDA is a standard industry ratio in the midstream sector. Many midstream management teams, both investment grade and speculative grade, actively manage to a very similar level of leverage, with many targeting reported Debt / EBITDA of 4.0x, which Moody's considers to be representative of the Ba rating category.

#### FFO – Maintenance CAPEX / Distributions

Moody's uses the distribution coverage ratio, a measure of cash flow coverage distributions, as a reflection of a company's financial policy. The ratio is defined as Funds Flow from Operations (FFO) less maintenance capital expenditures divided by distributions. Maintenance capital expenditures are generally based on public disclosures of maintenance capital spending or, if not disclosed, 100% of a company's annual depreciation and amortization expense, and our forward view of maintenance spending requirements. Companies with lower payouts and which apply free cash flow towards debt reduction and reinvestment map to higher ratings. High distribution coverage provides companies with cushion during periods of weaker earnings, particularly those companies with higher levels of cash flow volatility, and provides a higher level of financial flexibility.

For midstream MLPs in the peer group that have temporarily eliminated or substantially reduced their distributions as a result of operating or financial distress, we adjust the mapping in this sub-factor to reflect the expectation of a more normalized distribution policy that is likely to occur over the near to medium term.

While not captured in the distribution coverage ratio, our analysis also considers total capital spending plans, as maintenance capital spending is unlikely to capture the full extent of spending required to grow. We also consider acquisitions as part of this analysis, particularly smaller, routine acquisitions, which is another important source of growth for the midstream peer group.

### Factor 3: Financial Leverage & Distribution Profile (40%)

	Aaa	Aa	A	Baa	Ba	B	Caa
EBITDA / Interest Expense	≥ 20x	12 - 20x	8 - 12x	4 - 8x	2 - 4x	1 - 2x	< 1x
Debt / EBITDA	< .5x	.5 - 1x	1 - 2.5x	2.5 - 3.5x	3.5 - 5x	5 - 7x	≥ 7x
(FFO - Maintenance CAPEX) / Distributions	≥ 10x or N/A	5 - 10x	2 - 5x	1.4 - 2.0x	1.2 - 1.4x	1 - 1.2x	< 1x

A chart that illustrates grid mapping results for Factor 3 and a discussion of outliers is included in Appendix C.

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### Assumptions and Limitations and Rating Considerations That are not Covered in the Grid

This grid that is part of this rating methodology incorporates a trade-off between simplicity that enhances transparency and greater complexity that would enable the grid to map more closely to actual ratings. The three rating factors in the grid do not constitute an exhaustive treatment of all of the considerations that are important for ratings of global midstream energy companies.

In choosing metrics for the grid, we did not include certain important factors that are common to all companies in any industry, such as the quality and experience of management, assessments of corporate governance and the quality of financial reporting and information disclosure. The assessment of these factors can be highly subjective and variable over time. Accordingly, ranking them by rating category in a grid would, in some cases, suggest too much precision and stability in the relative ranking of particular issuers against all other issuers that are rated in various industry sectors.

Ratings may include additional factors that are difficult to quantify or that only have a meaningful effect in differentiating credit quality in some cases. Such factors include regulatory and litigation risk as well as management strategy, growth strategy and macroeconomic trends. While these are important considerations, it is not possible to precisely express these in the grid without making the grid excessively complex and less transparent.

Ratings may also reflect circumstances in which the weighting of a particular factor will be different from the weighting suggested by the grid. For example, financial leverage at a high level could have an impact that is greater than suggested by the grid weighting. This variation in weighting as a rating consideration can also apply to factors that we chose not to attempt to represent in the grid. For example, liquidity is a rating consideration that can sometimes be critical to ratings and under other circumstances may not have a substantial impact in discriminating between two issuers with a similar credit profile. Ratings can be heavily affected by extremely weak liquidity that magnifies default risk. However, two identical companies might be rated the same if their only differentiating feature is that one has a good liquidity position while the other has an extremely good liquidity position. This illustrates some of the limitations for using grid-indicated ratings to predict rating outcomes.

Our ratings incorporate expectations for future performance, while the financial information used to illustrate the mapping in the grid is mainly historical. In some cases, our expectations for future performance may be informed by confidential information that we cannot publish. In other cases, we estimate future results based upon past performance, industry trends, our expectations for the likely range of future supply, demand and prices, competitor actions and other factors. In either case, predicting the future is subject to the risk of substantial inaccuracy. Assumptions that can cause our forward looking expectations to be incorrect include unanticipated changes in any of the following factors: the macroeconomic environment and general financial market conditions, industry competition, new technology, regulatory actions, global and regional supply and demand trends for crude oil, natural gas, natural gas liquids and refined petroleum products.

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### Other Considerations: Publicly-traded Partnerships' Corporate Finance Model

The majority of the rated midstream peer group is comprised of master limited partnership (MLPs) or their equivalent (LLCs). MLPs typically follow a corporate finance model that incorporates a number of credit-negative attributes – high distribution payouts, financing risk, acquisition event risk and weak corporate governance. These risks result in ratings that are lower than they would be otherwise – we typically haven't rated midstream MLPs rated above the Baa rating level.

Under their partnership agreements, MLPs pay out 100% of available cash after operating expenses, maintenance capital, debt service and reasonable reserves. With a MLP's value predicated on high cash payouts, publicly-traded partnerships have less ability to tolerate volatility in their performance.

The partnerships' high payouts inhibit internal credit accretion and make partnerships reliant on external financing for growth capital and vulnerable to financial market conditions. Moreover, each equity issuance at a MLP comes with the price of an higher distribution burden and the need to have cash flows to support the incremental distribution. Additionally, given the prominence of yield, MLP values can be sensitive to interest rate movements, performing better in steady-to-declining rate environments.

MLP partnership agreements provide for a sharing of distributions between the common unitholders and the General Partner (GP). Most MLPs have an incentive distribution rights (IDR) structure, whereby the GP gets a higher proportion of total payouts, the higher the distributions-per-common partnership unit. Under this mechanism, payouts to the GP grow at a faster rate and could increase the MLP's cost of capital longer term<sup>2</sup>. There are a number of publicly-traded GPs and GPs with their own debt obligations. An affiliation with a leveraged GP presents potential for distribution pressure or some type of event risk that could be credit negative to the MLP.

Event risk is implicit in this model, since partnerships are positioned as acquisition or large capital project growth vehicles. Moreover, since the typical midstream MLP's assets are generally mature, they make serial acquisitions to grow. As the sector has matured, many midstream MLPs have grown into areas where they have lacked in-house expertise or into business lines, such as marketing and trading, that require strong internal controls, or have grown via complex capital structures/organizations. In addition, many companies in the peer group are relatively young or have been owned by their current sponsor for only a brief time, not yet establishing a track record.

#### Corporate Governance

The separation of ownership and control inherent to the MLPs' corporate governance structure leads Moody's to expect stronger financial ratios for MLPs relative to comparably rated public corporations. The central governance risk is that the common unit holders have no control over the MLP, so the GP potentially can extract value from the MLP to the detriment of common unitholders and bondholders. However, this risk is mitigated first by the fact that MLPs rely on continued access to equity and debt markets for growth capital, and, therefore, in practice they have substantial incentives to take into account the interests of common unitholders and bondholders. Second, to the extent that the GP is a substantial owner of common units, we see less risk relative to other MLPs<sup>3</sup>. A notable recent trend has been for MLPs to buy-in the GP and eliminate the IDR function discussed above, which we view favorably from a corporate governance and bondholder stand point.

#### Liquidity

Midstream MLPs generally maintain sizable credit facilities, primarily for acquisitions and capital spending, since midstream businesses (except marketing, propane and fuel oil) generally do not require much working capital. However, lack of market access could leave midstream MLPs vulnerable to a liquidity problem, because high payouts leave little liquidity cushion. Midstream MLPs are made more vulnerable when they have large amounts of short-term debt outstanding after acquisitions. The assumption implicit in a typical midstream MLP acquisition is "borrow now, term out later." However, if MLPs are unable to refinance maturing debt or to renew their bank lines, they will be

<sup>2</sup> Please refer to Moody's Special Comment [MLP Incentive Distribution Rights Reduce Long-Term Competitiveness](#), August 2007.

<sup>3</sup> Please refer to Moody's Special Comment [Corporate Governance Structure of Master Limited Partnerships Carries Credit Risk](#), May 2007.

pressed to meet their debt obligations and distributions. The MLP equity market is less liquid than for C-Corps and is arguably more confidence sensitive. Distributions could be reduced or cut, but this would cause unit prices to fall precipitously and deter access to the equity market. In some cases, the MLP's general partner or corporate sponsor has had to "inject" cash to cover distribution payments. This injection of cash can be easily disguised through direct cash investments into the MLP, private sales of equity from the general partner directly into the MLP, or asset-drop transactions.

#### Notching Considerations

We assess a MLP on a standalone level as well as on a consolidated family level, including debt of the GP sponsor if it relies on distributions from the MLP to service its debt and to pay its own distributions. A Corporate Family Rating is assigned at the upper-most entity with rated debt in the legal organization. Because such GPs are generally leveraged, they have tended to be rated in the Ba level. Non-investment grade GPs and affiliates are rated according to the Moody's Loss Given Default methodology. Historically, GP sponsors have been rated 0-4 notches below investment-grade MLPs, depending on the degree of explicit or implicit insulation provided by the partnership agreement, financial policies, or corporate governance mechanisms. The notching also considers whether the GP has its own businesses that provide cash flow to service its debt. For GPs without independent businesses that rely solely on distributions from the MLP, we typically rate the GP's debt 2-3 notches below the MLP's debt rating. Although the GP's debt is non-recourse to the MLP, deterioration in the GP's credit quality could cause the MLP's ratings to be downgraded, though perhaps not in lock-step.

## Conclusion: Summary of the Grid-Indicated Rating Outcomes

The grid-indicated ratings shown for illustrative purposes are based on last twelve month financial data as of the quarter end closest to June 30, 2010. The grid-indicated ratings for a representative group of 12 midstream energy companies map to current assigned ratings as follows (see Appendix B for the details):

- » 6 companies map to their assigned rating
- » 6 companies have a grid-indicated rating that is within two alpha-numeric notches from their assigned rating

Overall, the framework indicates that there are an equal amount of companies whose grid-indicated rating is below their actual rating (3) and above their actual rating (3).

## Appendix A: Midstream Energy Industry Factor Grid

	Weights	Aaa	Aa	A	Baa	Ba	B	Caa
<b>Factor 1: Scale</b>								
PP&E (US\$ MM)	15.0%	≥ \$25,000	\$10,000 < \$25,000	\$5,000 < \$10,000 or \$2,500 < \$5,000 w/dominant position in protected market	\$2,500 < \$5,000 or \$1,000 < \$2,500 w/dominant position in protected market	\$1,000 < \$2,500	\$300 < \$1,000	< \$300
EBITDA (US\$ MM)	15.0%	≥ \$5,000	\$2,000 < \$5,000	\$1,000 < \$2,000 or \$500 < \$1,000 w/dominant position in protected market	\$500 < \$1,000 or \$200 < \$500 w/dominant position in protected market	\$200 < \$500	\$50 < \$200	< \$50
<b>Factor 2: Business Risk</b>								
Estimated Price & Volume Risk Exposure	30.0%	Expected to have nil medium to long term volume risk, no direct commodity price risk, strong commercial outlook and/or protected market, high proportion of long term contracts with highly rated counterparties	Expected to have modest long-term volume risk but no medium term risk, no direct commodity price risk, strong commercial outlook and/or protected market, high proportion of medium and long term contracts with highly rated counterparties	Expected to have limited medium term volume risk, no direct commodity price risk, strong commercial outlook and/or protected market, high proportion of medium term contracts with highly rated counterparties	Expected to have modest near to medium term volume risk, limited direct commodity price risk, strong commercial outlook	Expected to have significant volume risk, modest direct commodity price risk	Expected to have substantial volume risk, substantial direct commodity price risk	Expected to have very high price and volume risk, primarily of a speculative nature
<b>Factor 3: Financial Leverage &amp; Distribution Profile</b>								
EBITDA / Interest Expense	15.0%	≥ 20x	12 - 20x	8 - 12x	4 - 8x	2 - 4x	1 - 2x	< 1x
Debt / EBITDA	15.0%	< .5x	.5 - 1x	1 - 2.5x	2.5 - 3.5x	3.5 - 5x	5 - 7x	≥ 7x
(FFO - Maintenance CAPEX) / Distributions	10.0%	≥ 10x or N/A	5 - 10x	2 - 5x	1.4 - 2.0x	1.2 - 1.4x	1 - 1.2x	< 1x

## Appendix B: Grid-Indicated Ratings

Issuer	Senior Unsecured or Corporate Family Rating	Grid-Indicated Rating (Factors 1 to 3)	Scale		Business Risk	Financial Leverage & Distribution Profile		
			PP&E (US\$ MM)	EBITDA (US\$ MM)	Estimated Price and Volume Risk Exposure	EBITDA / Interest Expense	Debt / EBITDA	(FFO - Maintenance CAPEX) / Distributions
			15%	15%	30%	15%	15%	10%
Colonial Pipeline Company	A2	A3	Baa	A	Aa	Baa	A	Ba
DCP Midstream, LLC	Baa2	Baa3	A	A	Ba	Baa	Baa	Baa
Kinder Morgan Energy Partners, L.P.	Baa2	Baa2	Aa	Aa	Baa	Baa	Ba	B
Magellan Midstream Partners, L.P.	Baa2	Baa2	Baa	Ba	A	Baa	Ba	Ba
ONEOK Partners, L.P.	Baa2	Baa3	A	Baa	Baa	Ba	Ba	Caa
Enterprise Products Partners L.P.	Baa3	Baa2	Aa	Aa	Baa	Baa	Ba	Ba
Plains All American Pipeline L.P.	Baa3	Baa3	A	A	Baa	Ba	B	B
Suburban Propane Partners, L.P.	Ba2	Ba2	B	Ba	Ba	Baa	A	Baa
Holly Energy Partners, L.P.	Ba3	Ba3	B	B	Ba	Ba	Ba	Ba
Niska Gas Storage	Ba3	Ba2	Ba	Ba	Ba	Baa	Ba	Caa
Regency Energy Partners LP	Ba3	Ba3	Ba	Ba	Ba	Ba	B	Caa
MarkWest Energy Partners, L.P.	Ba3	Ba2	Ba	Ba	Ba	Ba	Ba	Ba

Data as of June 30, 2010

Ratings at November 2010

Positive Outliers - grid-indicated outcome on a specific sub-factor is at least two broad rating categories higher than the actual rating assigned.

Negative Outliers - grid-indicated outcome on a specific sub-factor is at least two broad rating categories lower than the actual rating assigned.

## Appendix C: Observations and Outliers for Grid Mapping

### Factor 1 – Scale (30%)

Issuer	Senior Unsecured or Corporate Family Rating	PP&E (US\$ MM)	EBITDA (US\$ MM)
		15%	15%
Colonial Pipeline Company	A2	Baa	A
DCP Midstream, LLC	Baa2	A	A
Kinder Morgan Energy Partners, L.P.	Baa2	Aa	Aa
Magellan Midstream Partners, L.P.	Baa2	Baa	Ba
ONEOK Partners, L.P.	Baa2	A	Baa
Enterprise Products Partners L.P.	Baa3	Aa	Aa
Plains All American Pipeline L.P.	Baa3	A	A
Suburban Propane Partners, L.P.	Ba2	B	Ba
Holly Energy Partners, L.P.	Ba3	B	B
Niska Gas Storage	Ba3	Ba	Ba
Regency Energy Partners LP	Ba3	Ba	Ba
MarkWest Energy Partners, L.P.	Ba3	Ba	Ba

Data as of June 30, 2010

Ratings at November 2010



Positive Outliers - grid-indicated outcome on a specific sub-factor is at least two broad rating categories higher than the actual rating assigned.

Negative Outliers - grid-indicated outcome on a specific sub-factor is at least two broad rating categories lower than the actual rating assigned.

The mapped ratings for scale correlate well with the credit ratings of the midstream energy peer group. Enterprise Products and Kinder Morgan are both positive outliers on this factor. Both companies represent the largest midstream energy companies in the peer group, with much larger asset bases and EBITDA than their nearest competitors. However, their ratings are restrained by weaker leverage and high payout ratios.

## Factor 2 – Business Risk (30%)

Issuer	Senior Unsecured or Corporate Family Rating	Estimated Price and Volume Risk Exposure
		30%
Colonial Pipeline Company	A2	Aa
DCP Midstream, LLC	Baa2	Ba
Kinder Morgan Energy Partners, L.P.	Baa2	Baa
Magellan Midstream Partners, L.P.	Baa2	A
ONEOK Partners, L.P.	Baa2	Baa
Enterprise Products Partners L.P.	Baa3	Baa
Plains All American Pipeline L.P.	Baa3	Baa
Suburban Propane Partners, L.P.	Ba2	Ba
Holly Energy Partners, L.P.	Ba3	Ba
Niska Gas Storage	Ba3	Ba
Regency Energy Partners LP	Ba3	Ba
MarkWest Energy Partners, L.P.	Ba3	Ba

Data as of June 30, 2010

Ratings at November 2010



Positive Outliers - grid-indicated outcome on a specific sub-factor is at least two broad rating categories higher than the actual rating assigned.

Negative Outliers - grid-indicated outcome on a specific sub-factor is at least two broad rating categories lower than the actual rating assigned.

The “Business Risk” factor tracks actual ratings closely and there are no outliers. Most of the companies are assessed at either “Ba” or “Baa” for this factor, with only two companies assessed higher than “Baa”. This is indicative of the trend of creeping business risk in the sector.

## Factor 3: Financial Leverage &amp; Distribution Profile (40%)

Issuer	Senior Unsecured or Corporate Family Rating	EBITDA / Interest Expense	Debt / EBITDA	(FFO - Maintenance CAPEX) / Distributions
		15%	15%	10%
Colonial Pipeline Company	A2	Baa	A	Ba
DCP Midstream, LLC	Baa2	Baa	Baa	Baa
Kinder Morgan Energy Partners, L.P.	Baa2	Baa	Ba	B
Magellan Midstream Partners, L.P.	Baa2	Baa	Ba	Ba
ONEOK Partners, L.P.	Baa2	Ba	Ba	Caa
Enterprise Products Partners L.P.	Baa3	Baa	Ba	Ba
Plains All American Pipeline L.P.	Baa3	Ba	B	B
Suburban Propane Partners, L.P.	Ba2	Baa	A	Baa
Holly Energy Partners, L.P.	Ba3	Ba	Ba	Ba
Niska Gas Storage	Ba3	Baa	Ba	Caa
Regency Energy Partners LP	Ba3	Ba	B	Caa
MarkWest Energy Partners, L.P.	Ba3	Ba	Ba	Ba

Data as of June 30, 2010

Ratings at November 2010

	Positive Outliers - grid-indicated outcome on a specific sub-factor is at least two broad rating categories higher than the actual rating assigned.
	Negative Outliers - grid-indicated outcome on a specific sub-factor is at least two broad rating categories lower than the actual rating assigned.

There are a number of negative outliers for Factor 3, namely under the distribution coverage ratio (FFO – Maintenance Capex/Distributions). Negative outliers include Colonial Pipeline, Kinder Morgan, ONEOK Partners, Plains All American and Regency Energy Partners. The negative outliers on this factor reflect the high financial leverage and payout ratios that are typically associated with the MLP model that most of these companies have adopted. While Colonial is private and is not a MLP, it maintains a high level of distributions. Helping to partially offset the weak financial metrics and high payouts is lower business risk (particularly in the case of Colonial) and substantial size and scale (particularly in the case of Kinder Morgan, ONEOK Partners and Plains All American).

Suburban Propane is a positive outlier, reflecting its low leverage. Suburban's rating remains restrained by its small asset base and earnings scale and the challenges of operating in the highly competitive and fragmented propane and fuel oil business.

## Appendix D: Midstream Energy Industry Overview

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### North American Dominated Industry

The midstream sector is largely comprised of U.S. and Canadian based companies. The North American energy industry has a long history of native crude oil and natural gas production that has given rise to a well developed infrastructure to extract, process and deliver energy commodity products. Internationally, midstream assets are largely part of integrated oil and gas companies, including major integrated oil companies, national oil companies, or independent exploration and production companies.

Both crude oil and natural gas exist in the same raw hydrocarbon stream. Because oil and gas exist in different states (liquid vs. gaseous), they are handled differently. Consequently, the “midstream” sector comprises a number of functions, depending on which hydrocarbon product is being handled and delivered. Crude oil midstream encompasses the transportation of crude oil from the well head to the refinery. Petroleum product midstream function begins at the refinery, where the product is picked up by the marketer from storage terminals. For natural gas, midstream encompasses gathering gas from wells, delivering it via small diameter pipelines to a facility that processes the raw gas into pipeline quality gas and natural gas liquids or NGLs (collectively referred to as gathering and processing or “G&P”), and transporting it on larger diameter pipelines to market. NGLs are further fractionated into their constituent parts. Midstream functions also include the storage of oil, refined products, natural gas and NGLs.

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### Preponderance of the Partnership Structure

The midstream peer group is dominated by MLPs. Publicly-traded partnerships issue partnership units carrying limited liability for unitholders, similar to shares of common stock in a corporation. Unlike corporations, partnerships do not pay U.S. income taxes. Instead, the partnership’s unitholders pay taxes on their share of the partnership’s income. However, much of this income is shielded by deductions for depreciation and amortization. This U.S. tax advantage is only available to qualifying natural resource and real estate assets under current tax law.

The general partner (GP) owns an equity stake in the partnership and manages its business. GP sponsors include energy companies, which use their partnership affiliate as a corporate finance tool to monetize assets in a tax-efficient structure without surrendering control of the assets, as well as a number of financial investors.

Partnership units have also become common currency for acquisitions. Because partnerships do not pay U.S. income taxes, they may bid more aggressively for acquisitions against corporations, whose cost of capital could be higher because of income taxes.

Partnerships’ viability is subject to tax laws and regulation. Partnerships have flourished because of their tax advantage. Without it, they would lose their attraction in their current corporate form.

## Appendix E: Key Rating Issues over the Intermediate Term

### Creeping Business and Financial Risks

Historically, the midstream sector has been characterized by low business risk assets that are stable and long-lived, with low investment needs, and relatively higher leverage and payouts than other rated industrials. However, business and financial risk has been increasing across the peer group. Consequently, we have a negative ratings bias in the midstream sector.

The MLP business model requires partnerships to distribute available cash on a quarterly basis so MLPs need to raise debt and equity capital to fund growth capital spending and acquisitions. Therefore, MLPs compete for capital and attempt to differentiate themselves to investors by growing distributions. This leads to a desire to grow earnings and cash flow, either organically or through acquisitions, and management incentives are often based on this growth. MLPs originally bought midstream assets from larger integrated oil and E&P companies that viewed this business as non-core. As the midstream sector has matured, there have been fewer lower risk assets available for growth. As a result, we have begun to see some midstream companies expand into riskier business lines, such as gathering or processing or marketing or trading, in order to grow. We have also seen companies expand into non-traditional assets, such as refining and barges. Many MLPs have conducted marketing and trading activities, including contango activities, to take advantage of their storage and transportation assets. However, these businesses require significant risk management systems and expertise; consume greater amounts of working capital, leading to higher liquidity needs; and raise the overall risk profile of the enterprise.

Additionally, leverage and coverage metrics have slowly eroded for many midstream energy companies. Since about 2002, leverage has gradually increased for most companies in the peer group, largely as a result of large capital spending programs and insufficient equity issuances, particularly during the financial crisis of 2009. Many companies have undertaken large organic spending programs, and the need to pay for these projects has led some companies to increase financial leverage ahead of cash flows that either do not come as quickly as anticipated, cost more than anticipated, or stall as a particular project or service gets delayed. Lowering leverage as a midstream MLP is challenging and often only achieved through earnings growth, as opposed to debt reduction.

### The Changing Dynamics of Oil and Gas Production and Transportation

The emergence of new oil and gas supplies has altered the competitive midstream landscape in North America, with new areas of oil and gas production in development and new midstream infrastructure serving them. The emergence of new natural gas shale plays in recent years has created increased midstream infrastructure demands and resulted in shifting natural gas supply routes. More recently, with relatively high oil and natural gas liquids prices and comparatively weaker natural gas prices, activity levels have shifted more towards oily and liquids rich natural gas areas.

Shifting supply dynamics has resulted in increased demand for midstream infrastructure and services. However, with expanded midstream infrastructure, competition is increasing and basis differentials are narrowing. The rise of shale developments has increased gas supply and displaced some transportation away from the traditional routes out of the Gulf Coast, Canada, and the Mid-Continent. In addition, basis differentials—the differences between regional gas prices—continue to narrow, largely thanks to new interstate pipelines such as the Rockies Express, Southeast Supply Header and Midcontinent Express. The narrower basis spreads offer good opportunities for producers to expand their markets to

the detriment of pipelines that have experienced the value of their transportation capacity decrease with increased competition.

The changing supply dynamics and increasing competition will likely pressure some midstream companies over the intermediate term, particularly small players that are more exposed to traditional natural gas markets. For older assets, this could result in lower utilization rates and potentially stranded assets over the longer term.

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### Midstream Infrastructure Build Out Continues

The midstream sector has been experiencing a surge in organic-growth projects over the last several years, as the emergence of new oil and gas supplies in North America has created a need for new pipelines and gathering and processing facilities to support them. We expect spending levels will remain high over the intermediate term in emerging shale plays, such as the Marcellus in Appalachia, the Bakken in North Dakota and Montana, the Haynesville in Louisiana, the Eagle Ford in Texas, and the Horn River in British Columbia.

However, with the high spending levels continuing, project execution and financing risk remains. In addition, there is a risk of overcapacity developing in the long run, particularly as a number of natural gas shale plays require relatively high natural gas prices to be economic and have little production history. In the typical production curve of a shale play, flush initial production rapidly gives way to a decline that could result in low volumes relative to capacity levels. Consequently, the uncertain longevity of shale gas reserves necessitates the need for midstream energy companies to recover capital over a short time period. Furthermore, counterparty credit quality is increasingly a concern, with many projects counterparties comprising non-investment grade E&P companies.

» contacts continued from page 1

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