

Research Update:

Southern Star Central Corp. And Southern Star Central Gas Pipeline Inc. Outlooks Revised To Positive From Stable

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Related Criteria And Research

Ratings List

Research Update:

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Overview

- We revised the outlooks on Southern Star Central Corp. and its subsidiary, natural gas pipeline company Southern Star Central Gas Pipeline Inc., to positive from stable.
- We also affirmed the 'BBB-' corporate credit rating and 'BB+' issue-level rating for unsecured debt at Southern Star Central Corp.
- The outlook revisions are based on improving credit metrics and the company's excellent business profile.

Rating Action

On July 20, 2010, Standard & Poor's Ratings Services revised the outlooks on Southern Star Central Corp. (Central) and Southern Star Central Gas Pipeline Inc. (Pipeline). We also affirmed the 'BBB-' corporate credit ratings on both entities. The outlook revisions are based on the company's excellent business profile and improved credit metrics as a result of a June 2009 rate case decision. As of March 31, 2010, the company had \$516 million total debt, including adjustments for postretirement benefit obligations, accrued interest, asset retirement obligations, and operating leases.

Rationale

Central's revenues come entirely from its wholly-owned subsidiary Pipeline, which owns a regulated interstate natural gas pipeline system that has a mainline capacity of 2.4 billion cubic feet (bcf) of natural gas per day. The mainline supplies gas from Kansas, Oklahoma, Wyoming, and Texas to its primary markets in the major metropolitan areas of Kansas and Missouri. The company also operates eight underground storage facilities, with an aggregate capacity of 43 bcf and delivery capacity of 1.2 bcf of natural gas per day. GE Energy Financial Services Inc. (EFS; a wholly-owned subsidiary of General Electric Co. [AA+/Stable/A-1+]) owns 60% of the pipeline company, and Morgan Stanley Infrastructure Partners (MSIP, not rated), an investment fund, owns the remaining 40%. Caisse de depot et placement du Quebec (CDP; AAA/Stable/A-1+) sold its 40% stake to MSIP effective March 9, 2010.

The 'BBB-' rating reflects the following strengths:

- Reservation charges provide stable revenues which accounted for 92% of revenues in 2009, and which we expect to remain above 90%. Multiple pipelines and storage fields provide operational flexibility for shippers and support the pipeline's competitive position.

- Ready access to several supply basins in Texas, Oklahoma, and the Rocky Mountains through several interconnects.
- The weighted average rating of shippers is 'BB', and the weighted average remaining life of contracted transportation capacity is about five years. The credit profile of shippers is likely higher than the 'BB' level because approximately 20% are unrated local distribution companies (LDCs).

The following risks offset the strengths:

- High customer concentration increases risk, with regulated gas utilities Missouri Gas Energy (a subsidiary of Southern Union Co. [BBB-/Stable/--]) and Kansas Gas Service Co. (a subsidiary of ONEOK Inc. [BBB/Stable/A-2]) contributing more than half of the company's revenues.
- If operating costs increase or additional spending is necessary, liquidity may become constrained due to the lack of a revolving credit facility and a dividend policy that pays all excess cash to equity owners.
- The company faces recontracting risk because the bonds mature more than a year and a half beyond the weighted average remaining life of the contracts. As a result, a majority of the contracts will need to be renewed to ensure insure contractual coverage of cash flows for debt service.

Central's excellent business profile reflects our belief that cash flows will be fairly stable and predictable in the near term. The pipeline system's 23 interconnects and eight storage fields attract additional revenues from park-and-loan services and interruptible contracts. The contracts with Missouri Gas Energy and Kansas Gas Service Co. supply 36% and 20% of Pipeline's reservation charges, respectively, and expire in 2013. Recontracting risk is somewhat mitigated by the relatively light competition from other pipelines in the region, Central's flexible service offerings, and the pipeline system's wide geographic footprint. These factors should assist in renewing contracts or finding new customers.

Pipeline filed a rate case with The Federal Energy Regulatory Commission (FERC) on April 30, 2008, primarily to increase transportation and storage rates. In June 2009, the FERC issued an order approving a \$20 million increase in revenues over the base period of the 12 months ended Jan. 31, 2008. Central is required to file another rate case by December 2013.

The company plans to expand the capacity at the existing Elk City Storage Field by 4 million decatherms (working gas). Three customers will enter into firm storage agreements for the entire expansion effective April 1, 2011. Management expects the expansion to provide about \$5 million revenues annually and cost \$23 million. The ratings incorporate the assumption that the project will be funded in a balanced manner.

The company's financial profile is aggressive. Our financial analysis considers the consolidated debt of the parent company and the subsidiary. Credit metrics improved in 2009 due to the additional revenues from the rate case and lower capital spending. The company recently completed several low-risk projects which were supported by contracted cash flow. Capital spending, including the projects, has averaged more than \$50 million annually in the three years prior to 2009, when it declined to about \$40 million. We expect management to maintain it at \$40 million - \$50 million annually in the next few years. For the 12 months ended March 31, 2010, consolidated adjusted funds from operations (FFO) to total debt increased to 15.2%, FFO interest

coverage to 3.3x, and consolidated debt to EBITDA dropped to 4.4x, from 13%, 3.0x, and 5.3x as of the end of 2008. Standard & Poor's expects FFO to total debt to remain at about 15%. We consider these ratios to be strong for the 'BBB-' credit rating.

The 'BB+' rating on Central's \$250 million notes due 2016 is one notch below the 'BBB-' credit rating, reflecting the structural subordination of the parent company's debt to Pipeline's \$230 million senior unsecured debt. Due to the operating subsidiary/holding-company structure, we notch down the ratings on Central's debt.

Short-term credit factors

We view Central's overall liquidity as adequate. For the upcoming 12 months we expect liquidity sources to exceed uses by approximately 1.4x.

Cash sources consist of projected FFO of approximately \$80 million and cash of about \$35 million. The company does not maintain a revolver. Cash uses consist of maintenance capital requirements of \$50 million and approximately \$30 million of shareholder distributions. We expect the dividends to roughly equal net income. Other potential cash uses, such as working capital needs, are not significant.

In absolute dollars, we expect cash sources to exceed uses by roughly \$30 million during the next 12 months. This difference will remain positive even if EBITDA falls by more than 25%, which we would not expect given the highly contracted nature of the pipeline's cash flows.

In terms of other qualitative factors, we would expect that the pipeline would curtail dividends to its sponsors, should operating cash flows drop or capital expenditures increase.

Outlook

The positive outlooks on Central and Pipeline reflect improved cash flows that have benefitted from the rate increase and that we believe will comfortably exceed the company's capital spending requirements. We could raise the rating if the company strengthens its liquidity and maintains FFO to debt above 15%, FFO interest coverage of 3x, and total debt to EBITDA below 5x on a sustained basis. Conversely, we could return the outlook to stable based on an unfavorable shift in treatment by regulators or an inability to recontract its capacity in the next few years. Specifically, we may look to lower the ratings if this results in FFO to debt below 12%, FFO interest coverage below 3x, and total debt to EBITDA more than 5x. A negative rating action could also result if EFS or MSIP indicate an unwillingness to provide liquidity or other credit support.

Related Criteria And Research

- Industry Report Card: Favorable Market Conditions For U.S. Midstream Energy Companies In The First Half Of 2010 Despite Weak Gas Prices, published June 17, 2010.

- Rating Criteria for U.S. Midstream Energy Companies, published Dec. 18, 2008.

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Southern Star Central Corp.		
Corporate Credit Rating	BBB-/Positive/--	BBB-/Stable/--
Senior Unsecured	BB+	
Southern Star Central Gas Pipeline Inc.		
Corporate Credit Rating	BBB-/Positive/--	BBB-/Stable/--
Senior Unsecured	BBB-	

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