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Research Update:

Southern Star Central's 'BBB-' Credit Rating Affirmed On Purchase Of 40% Stake By Morgan Stanley Infrastructure Partners

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Research Update:

Southern Star Central's 'BBB-' Credit Rating Affirmed On Purchase Of 40% Stake By Morgan Stanley Infrastructure Partners

Overview

- We have affirmed the 'BBB-' issuer credit rating on Southern Star Central Corp. (Central) and wholly owned subsidiary Southern Star Central Gas Pipeline Inc. (Pipeline). The outlooks on the companies are stable.
- We have also affirmed the 'BB+' issue-level rating on debt issued by Central, which is notched down from the issuer credit rating due to its structural subordination as the holding company of operating company Pipeline.
- The affirmations follow an announcement that Morgan Stanley Infrastructure Partners (MSIP; not rated) will purchase Caisse de depot et placement du Quebec's (CDP; AAA/Stable/A-1+) 40% stake in Central, which we believe to be a credit-neutral event.

Rating Action

On Feb. 11, 2010, Standard & Poor's Ratings Services affirmed its 'BBB-' issuer credit rating on Central. The outlook is stable. As of Sept. 30, 2009, Central had $514 million of total adjusted debt. Today the company announced that MSIP plans to purchase CDP's 40% stake in Central. This ownership position also carries equal board voting rights with GE Energy Financial Services Inc.'s (EFS; a wholly-owned subsidiary of General Electric Co., AA+/Stable/A-1+) 60% economic ownership of Central.

We believe that the ownership sale will not result in any change to sponsor support already factored into the rating. This includes liquidity support for Central when necessary and a continuation of the current dividend policy of distributing an amount approximately equal to net income each quarter.

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. EFS owns 60% of the pipeline company and CDP owns the other 40%, through their indirect ownership of EFS-SSCC Holdings LLC (not rated). The change from CDP to MSIP will not affect the ratings. We consider the structure bankruptcy remote, as the two sponsors have equal representation on Central's board and voting rights.

The 'BBB-' rating reflects the following strengths:

- Reservation charges, which we expect to provide more than 90% of revenues, support the pipeline's stable revenues.
- 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 provides some geographic diversity of supply.
- The credit profile of shippers is likely higher than the 'BB' weighted average rating of shippers because approximately 20% are unrated local distribution companies (LDCs).
- The five-year weighted average life of shipping agreements is roughly equal to the average of other rated pipelines.

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 substantially 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.

Central's excellent business profile reflects our belief that cash flows will be fairly stable and predictable in the near term. The pipeline's 23 interconnects and eight storage fields attract additional revenues from park-and-loan services and interruptible contracts. Central's contracts with its two largest customers, Missouri Gas and Kansas Gas, supply 36% and 20% of Pipeline's reservation charges, respectively, and extend to 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's wide geographic footprint. These factors should assist in renewing contracts or finding new customers.

On Nov. 1, 2008, management implemented a rate increase that benefited cash flows in 2009 and beyond. The company filed the rate case on April 30, 2008, to increase transportation and storage rates, among other requests. The FERC approved the rate increase in June 2009, with 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.

We view the company's financial risk as aggressive. Our analysis considers Central's consolidated debt. Credit metrics improved in 2009, primarily due to increased revenues from the rate case and lower capital spending. We expect the metrics to hold relatively steady or decrease slightly with high capital spending in 2010 due to the planned expansion of its Elk City Gas Storage Field. We also expect annual capital spending of about $40 million for the next three years, with an additional $23 million for Elk City over 2010 and 2011. Consolidated adjusted funds from operations (FFO) to total debt was 15.5%, FFO interest coverage was 3.3x, and consolidated debt to EBITDA was 4.3x, as of Sept. 30, 2009. Standard & Poor's expects FFO to total debt to remain at about 14% and debt to EBITDA below 5x during the next three years. We consider these ratios adequate for the 'BBB-' issuer credit rating.

We rate Central's $250 million notes due 2016 'BB+', one notch below the 'BBB-' issuer credit rating, reflecting the structural subordination of its debt to Pipeline's priority obligations and $230 million senior unsecured debt. Pipeline is Central's sole operating subsidiary and the source of its operating funds. The structural subordination of Central's debt results from the operating subsidiary/holding-company structure and a ratio of priority obligations to assets of greater than 20%.

Liquidity

Central maintains adequate liquidity. Cash from operations is the company's primary source of liquidity, totaling about $75 million for the twelve months ended Sept. 30, 2009, which is in line with our expectations. The company has maintained a cash balance between $20 million and $40 million historically ($43 million as of Sept. 30, 2009). The company does not maintain a revolving credit facility, as equity contributions from the sponsors are expected if additional funding is necessary. We view the lack of a credit facility as negative because a significant expense could place pressure on Central's liquidity profile.

The primary uses of cash are capital expenditures and dividends. Capital spending for the 12 months ended Sept. 30, 2009, totaled $42 million, and we expect it to rise to $65 million in 2010. The dividend policy is to pay out a total approximately equal to net income each quarter, which we expect to be about $25 annually.

Outlook

The stable outlook on Central reflects our belief that cash flows will comfortably exceed the company's capital spending requirements. We could consider raising the rating if FFO to debt improves to about 17%, FFO interest coverage improves to 3.5x, and total debt to EBITDA remains below 4.5x. A higher rating would also require additional sources of liquidity. Conversely, a lower rating could result from 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 5.5x. A lower rating could also result if EFS or MSIP indicate an unwillingness to provide timely credit support as needed by Central.

Related Research

- Rating Criteria for U.S. Midstream Energy Companies, Dec. 18, 2008.
- Industry Report Card: Amid Market Uncertainty U.S. Midstream Energy Companies Enter 2010 On Stable Footing, Jan. 21, 2010.
- Issuer Ranking: U.S. Midstream Energy Companies, Strongest to Weakest, Jan. 7, 2010.
- Top 10 Investor Questions: U.S. Midstream Energy Companies, Jan. 22, 2010.

Ratings List

Ratings Affirmed

Southern Star Central Corp.	
Southern Star Central Gas Pipeline Inc.	
Corporate Credit Rating	BBB-/Stable/--
Southern Star Central Corp.	
Senior Unsecured (2 issues)	BB+
Southern Star Central Gas Pipeline Inc.	
Senior Unsecured (1 issue)	BBB-

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