ENERGY TRANSFER PARTNERS LP
Form 10-Q
July 15, 2004

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FORM 10-Q

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended May 31, 2004

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Transition Period from _________ to

Commission file number 1-11727

ENERGY TRANSFER PARTNERS, L.P.

(Exact name of registrant as specified in its charter)

Delaware (state or other jurisdiction or incorporation or organization)	**73-1493906** (I.R.S. Employer Identification No.)

2838 Woodside Street
Dallas, Texas 75204
(Address of principal executive offices and zip code)

(918) 492-7272
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes x No o

At July 12, 2004, the registrant had units outstanding as follows:

Energy Transfer Partners, L.P.	44,559,031	Common Units

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ENERGY TRANSFER PARTNERS, L.P.

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PART I FINANCIAL INFORMATION

The financial statements of Energy Transfer Partners, L.P. presented herein for the nine months ended May 31, 2004 include the results of operations for Energy Transfer Company for the entire period from September 1, 2003 through May 31, 2004, but include the results of operations for Heritage Propane Partners, L.P. (referenced herein as Predecessor Heritage) only for the period from January 20, 2004 to May 31, 2004. Thus, the results of operations do not represent the entire results of operations for Predecessor Heritage for the nine months ended May 31, 2004, as they do not include the results of operations of Predecessor Heritage for the period prior to the Energy Transfer Transactions on January 20, 2004. Please read notes 1 and 2 to the Consolidated Financial Statements for further explanation of the Energy Transfer Transactions.

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ITEM 1. FINANCIAL STATEMENTS

ENERGY TRANSFER PARTNERS, L.P. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except unit data)
(unaudited)

	May 31, 2004	August 31, 2003	August 31, 2003
	(see Note 2)	(Energy Transfer Company)	(Predecessor Heritage)
ASSETS			
CURRENT ASSETS:			
Cash and cash equivalents	$ 63,245	$ 53,122	$ 7,117
Marketable securities	2,658		3,044
Accounts receivable, net of allowance for doubtful accounts	234,072	105,987	35,879
Accounts receivable from related companies	662		
Inventories	38,427	3,947	45,274
Deposits paid to vendors	1,547	19,053	
Exchanges receivable	2,261	1,373	
Price risk management asset	2,181	928	
Prepaid expenses and other	5,705	770	2,824
Total current assets	350,758	185,180	94,138
PROPERTY, PLANT AND EQUIPMENT, net	957,878	391,264	426,588
INVESTMENT IN AFFILIATES	7,934	6,844	8,694
GOODWILL	290,624	13,409	156,595
INTANGIBLES AND OTHER ASSETS, net	95,886	5,406	52,824
Total assets	$ 1,703,080	$ 602,103	$ 738,839
LIABILITIES AND PARTNERS CAPITAL			
CURRENT LIABILITIES:			
Working capital facility	$ 7,030	$	$ 26,700
Accounts payable	247,841	114,198	43,690
Accounts payable to related companies	13,025	820	6,255
Exchanges payable	1,088	1,410	
Accrued and other current liabilities	47,415	19,655	35,573
Price risk management liabilities	574	823	

Income taxes payable	2,390	2,567	500
Current maturities of long-term debt	30,785	30,000	38,309
Total current liabilities	350,148	169,473	151,027
LONG-TERM DEBT, less current maturities	697,931	196,000	360,762
DEFERRED TAXES	111,898	55,385	
OTHER NONCURRENT LIABILITIES	3,676	157	
MINORITY INTERESTS	1,129		4,002
	1,164,782	421,015	515,791

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ENERGY TRANSFER PARTNERS, L.P. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(in thousands, except unit data)
(unaudited)

	May 31, 2004	August 31, 2003	August 31, 2003
	(see Note 2)	(Energy Transfer Company)	(Predecessor Heritage)
COMMITMENTS AND CONTINGENCIES			
PARTNERS CAPITAL:			
Common Unitholders (27, 919,974 and 6,628,817 units authorized, issued and outstanding at May 31, 2004 and August 31, 2003, respectively)	307,032	180,896	221,207
Class C Unitholders (1,000,000 and 0 units authorized, issued and outstanding at May 31, 2004 and August 31, 2003, respectively)			
Class D Unitholders (7,721,542 and 0 authorized, issued and outstanding at May 31, 2004 and August 31, 2003)	210,825		
Class E Unitholders (4,426,916 and 0 authorized, issued and outstanding at May 31, 2004 and August 31, 2003, respectively held by subsidiary and reported as treasury units)			
Special Units (3,742,515 and 0 authorized, issued and outstanding at May 31, 2004 and August 31, 2003)			
General Partner	18,466	192	2,190
Accumulated other comprehensive income (loss)	1,975		(349)
Total partners capital	538,298	181,088	223,048
Total liabilities and partners capital	$1,703,080	$ 602,103	$738,839

The accompanying notes are an integral part of these consolidated financial statements.

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ENERGY TRANSFER PARTNERS, L.P. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per unit and unit data)
(unaudited)

	Three Months Ended May 31, 2004	Three Months Ended May 31, 2003	Three Months Ended May 31, 2003	Nine Months Ended May 31, 2004	Eight Months Ended May 31, 2003	Nine Months Ended May 31, 2003
	(see Note 2)	(Energy Transfer Company)	(Predecessor Heritage)	(see Note 2)	(Energy Transfer Company)	(Predecessor Heritage)
REVENUES:						
Midstream and transportation	$ 505,691	$ 372,535	$	$ 1,408,968	$ 649,828	$
Affiliated - midstream		51			5,117	
Propane	122,850		113,039	255,303		441,358
Other	13,634		12,700	22,177		47,649
Total revenues	642,175	372,586	125,739	1,686,448	654,945	489,007
COSTS AND EXPENSES:						
Cost of products sold	530,130	329,650	66,781	1,442,586	570,170	252,221
Operating expenses	52,695	9,900	39,460	90,211	18,753	118,090
Depreciation and amortization	16,489	4,600	9,579	30,108	9,061	28,291
Selling, general and administrative	10,026	4,955	3,764	21,287	10,828	10,941
Realized and unrealized (gains) losses on derivatives	(3,352)	(1,367)		(13,554)	5,326	
Total costs and expenses	605,988	347,738	119,584	1,570,638	614,138	409,543
OPERATING INCOME	36,187	24,848	6,155	115,810	40,807	79,464

OTHER INCOME (EXPENSE):						
Interest, net	(12,234)	(4,498)	(8,950)	(24,881)	(9,449)	(27,563)
Equity in earnings of affiliates	179	48	504	506	1,491	1,687
Gain (loss) on disposal of assets	(263)		517	(235)		672
Other	(103)	11	(103)	130	79	(2,649)
INCOME (LOSS) BEFORE MINORITY INTERESTS AND INCOME TAXES	23,766	20,409	(1,877)	91,330	32,928	51,611
Minority interests	(67)		(90)	(242)		(1,038)
INCOME (LOSS) BEFORE INCOME TAXES	23,699	20,409	(1,967)	91,088	32,928	50,573
Income taxes	2,369	1,582	199	4,826	2,534	1,483
NET INCOME (LOSS)	21,330	18,827	(2,166)	86,262	30,394	49,090
GENERAL PARTNER S INTEREST IN NET INCOME	2,698	377	225	5,315	608	1,181
LIMITED PARTNERS INTEREST IN NET INCOME (LOSS)	$ 18,632	$ 18,450	$ (2,391)	$ 80,947	$ 29,786	$ 47,909
BASIC NET INCOME (LOSS) PER LIMITED PARTNER UNIT	$ 0.52	$ 2.79	$ (0.14)	$ 3.91	$ 4.50	$ 2.96
BASIC AVERAGE NUMBER OF UNITS OUTSTANDING	35,637,406	6,621,737	16,574,582	20,703,273	6,621,737	16,189,029

DILUTED NET INCOME (LOSS) PER LIMITED PARTNER UNIT	$ 0.52	$ 2.79	$ (0.14)	$ 3.90	$ 4.50	$ 2.95
DILUTED AVERAGE NUMBER OF UNITS OUTSTANDING	35,665,702	6,621,737	16,574,582	20,729,837	6,621,737	16,227,061

The accompanying notes are an integral part of these consolidated financial statements.

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ENERGY TRANSFER PARTNERS, L.P. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands, unaudited)

	Three Months Ended May 31, 2004	Three Months Ended May 31, 2003	Three Months Ended May 31, 2003	Nine Months Ended May 31, 2004	Eight Months Ended May 31, 2003	Nine Months Ended May 31, 2003
	(see Note 2)	(Energy Transfer Company)	(Predecessor Heritage)	(see Note 2)	(Energy Transfer Company)	(Predecessor Heritage)
Net income (loss)	$ 21,330	$ 18,827	$ (2,166)	$ 86,262	$ 30,394	$ 49,090
Other comprehensive income (loss)						
Reclassification adjustment for gains on derivative instruments included in net income	2,766		(125)	(3,134)		(552)
Reclassification adjustment for losses on available-for-sale securities included in net income						2,376
Change in value of derivative instruments	(3,762)		(406)	4,968		551
Change in value of available-for-sale securities	520		(253)	141		(262)
Comprehensive income (loss)	$ 20,854	$ 18,827	$ (2,950)	$ 88,237	$ 30,394	$ 51,203
Reconciliation of Accumulated Other Comprehensive Income (Loss)						
Balance, beginning of period	$ 2,451	$	$ (755)	$	$	$ (3,652)
Current period reclassification to earnings	2,766		(125)	(3,134)		1,824
Current period change	(3,242)		(659)	5,109		289

Balance, end of period	$ 1,975	$ —	$ (1,539)	$ 1,975	$ —	$ (1,539)

The accompanying notes are an integral part of these consolidated financial statements.

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ENERGY TRANSFER PARTNERS, L.P. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF PARTNERS CAPITAL
(in thousands, except unit data)
(unaudited)

	Number of Units				
	Common	**Class C**	**Class D**	**Class E**	**Special**
Balance, August 31, 2003	6,628,817				
Distribution to parent					
Unit distribution					
Merger with Predecessor Heritage	16,495,833	1,000,000	7,721,542		3,742,515
Conversion of Class E units	(4,426,916)			4,426,916	
Class E Units held by subsidiary and reported as treasury units				(4,426,916)	
Issuance of Common Units	9,200,000				
General Partner capital contribution					
Issuance of Common Units in connection with certain acquisitions	22,240				
Net change in accumulated other comprehensive income per accompanying statements					
Net income					
Balance, May 31, 2004	27,919,974	1,000,000	7,721,542		3,742,515

[Additional columns below]

[Continued from above table, first column(s) repeated]

	Common	Class C	Class D	Class E	Special	General Partner	Accumulated Other Comprehensive Income	Total
Balance, August 31, 2003	$ 180,896	$	$	$	$	$ 192	$	$ 181,088
Distribution to parent	(209,264)							(209,264)
Unit distribution	(19,544)		(5,405)			(1,919)		(26,868)
Merger with Predecessor Heritage	115,614		198,200			(1,973)		311,841
Conversion of Class E units	(157,340)			157,340				
Class E Units held by subsidiary and reported as treasury units				(157,340)				(157,340)
Issuance of Common Units	334,330							334,330
General Partner capital contribution	(1,027)		(284)			16,851		15,540
Issuance of Common Units in connection with certain acquisitions	734							734
Net change in accumulated other comprehensive income per accompanying statements							1,975	1,975
Net income	62,633		18,314			5,315		86,262
Balance, May 31, 2004	$ 307,032	$	$ 210,825	$	$	$ 18,466	$ 1,975	$ 538,298

The accompanying notes are an integral part of these consolidated financial statements.

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ENERGY TRANSFER PARTNERS, L.P. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine Months Ended May 31, 2004	Eight Months Ended May 31, 2003	Nine Months Ended May 31, 2003
	(see Note 2)	(Energy Transfer Company)	(Predecessor Heritage)
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 86,262	$ 30,394	$ 49,090
Reconciliation of net income to net cash provided by operating activities-			
Depreciation and amortization	30,108	9,059	28,291
Provision for loss on accounts receivable	996		1,978
Loss on write down of marketable securities			2,400
(Gain) loss on disposal of assets	235		(672)
Deferred compensation on restricted units and long-term incentive plan			929
Undistributed earnings of affiliates	(255)	(1,491)	(1,384)
Deferred income taxes	(827)	(1,791)	
Minority interests	155		698
Changes in assets and liabilities, net of effect of acquisitions:			
Accounts receivable	(60,044)	(75,934)	(10,272)
Accounts receivable from related companies	(151)	(1,895)	
Inventories	50,254	1,554	24,392
Deposits paid to vendors	17,506		
Exchanges receivable	(888)	(2,340)	
Prepaid and other expenses	1,981		5,602
Intangibles and other assets	197	198	(205)
Accounts payable	32,229	67,519	(8,650)
Accounts payable to related companies	(497)	1,662	2,651
Exchanges payable	(321)	1,056	
Accrued and other current liabilities	(6,915)	6,516	(4,277)
Income taxes payable	(177)	2,099	
Price risk management liabilities, net	332	707	
Net cash provided by operating activities	150,180	37,313	90,571

CASH FLOWS FROM INVESTING ACTIVITIES:			
Cash paid for acquisitions, net of cash acquired	(181,555)	(332,148)	(23,313)
Capital expenditures	(84,841)	(9,492)	(21,200)
Proceeds from the sale of assets	702	9,843	3,113
Net cash used in investing activities	(265,694)	(331,797)	(41,400)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from borrowings	364,238	246,000	127,029
Principal payments on debt	(360,659)	(12,500)	(187,036)
Net proceeds from issuance of Common Units	334,330		44,758
Capital contribution from General Partner	15,540	108,723	
Distributions to parent	(196,708)	(4,825)	
Debt issuance costs	(4,236)	(6,462)	
Unit distributions	(26,868)		(31,577)
Other			148
Net cash provided by/ (used) in financing activities	125,637	330,936	(46,678)
INCREASE IN CASH AND CASH EQUIVALENTS	10,123	36,452	2,493
CASH AND CASH EQUIVALENTS, beginning of period	53,122		4,596
CASH AND CASH EQUIVALENTS, end of period	$ 63,245	$ 36,452	$ 7,089

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ENERGY TRANSFER PARTNERS, L.P. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine Months Ended May 31, 2004	Eight Months Ended May 31, 2003	Nine Months Ended May 31, 2003
	(see Note 2)	(Energy Transfer Company)	(Predecessor Heritage)
NONCASH FINANCING ACTIVITIES:			
Notes payable incurred on noncompete agreements	$ —	$ —	$ 1,031
Issuance of Common Units in connection with certain acquistions	$ 734	$ —	$ 15,000
General Partner capital contribution	$ 1,311	$ —	$ 957
Distributions payable to parent	$ 12,556	—	$ —
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Cash paid during the period for interest	$ 21,249	$ 5,724	$ 26,089
Cash paid during the period for income taxes	$ 4,988	$ 3,250	$ —

The accompanying notes are an integral part of these consolidated financial statements.

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ENERGY TRANSFER PARTNERS, L.P. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollar amounts in thousands, except unit and per unit data)
(unaudited)

1. OPERATIONS AND ORGANIZATION:

Energy Transfer Transactions

On January 20, 2004, Heritage Propane Partners, L.P., (Heritage) and La Grange Energy, L.P. (La Grange Energy) completed the series of transactions whereby La Grange Energy contributed its subsidiary, La Grange Acquisition, L.P. and its subsidiaries who conduct business under the assumed name of Energy Transfer Company, (ETC) to Heritage in exchange for cash of $300,000 less the amount of Energy Transfer Company debt in excess of $151,500, less ETC s accounts payable and other specified liabilities, plus agreed upon capital expenditures paid by La Grange Energy relating to the ETC business prior to closing, $433,909 of Heritage Common and Class D Units, and the repayment of the ETC debt of $151,500. These transactions and the other transactions described in the following paragraphs are referred to herein as the Energy Transfer Transactions. In conjunction with the Energy Transfer Transactions and prior to the contribution of ETC to Heritage, ETC distributed its cash and accounts receivables to La Grange Energy and an affiliate of La Grange Energy contributed an office building to ETC. La Grange Energy also received 3,742,515 Special Units as consideration for the project it had in progress to construct the Bossier pipeline. The Special Units converted to Common Units upon the Bossier pipeline becoming commercially operational and such conversion being approved by Energy Transfer s Unitholders. The Bossier pipeline became commercially operational on June 21, 2004 and the Unitholders approved the conversion at a special meeting held on June 23, 2004. Because the conversion of the Special Units into Common Units was contingent upon events that occurred subsequent to May 31, 2004, those units have been excluded from the weighted average units used in computing net income per Limited Partner Unit. Additionally, the conversion of those units are not reflected in the consolidated balance sheet or statement of partners capital.

Simultaneously with the Energy Transfer Transactions, La Grange Energy obtained control of Heritage by acquiring all of the interest in U.S. Propane, L.P., (U.S. Propane) the General Partner of Heritage, and U.S. Propane, L.P. s general partner, U.S. Propane, L.L.C., from subsidiaries of AGL Resources, Atmos Energy Corporation, TECO Energy, Inc. and Piedmont Natural Gas Company, Inc. for $30,000 (the General Partner Transaction). In conjunction with the General Partner Transaction, U.S. Propane L.P. contributed its 1.0101% General Partner interest in Heritage Operating, L.P. (Heritage Operating) to Heritage in exchange for an additional 1% General Partner interest in Heritage. Simultaneously with these transactions, Heritage purchased the outstanding stock of Heritage Holdings, Inc. (HHI) for $100,000.

Concurrent with the Energy Transfer Transactions, La Grange Acquisition borrowed $325,000 from financial institutions and Heritage raised $355,948 of gross proceeds net of underwriter s discount through the sale of 9,200,000 Common Units at an offering price of $38.69 per unit. The net proceeds were used to finance the transaction and for general partnership purposes.

Accounting treatment of the Energy Transfer Transactions

The Energy Transfer Transactions were accounted for as a reverse acquisition in accordance with SFAS 141. Although Heritage is the surviving parent entity for legal purposes, ETC is the acquiror for accounting purposes. As a result, ETC s historical financial statements are now the historical financial statements of the registrant. Consequently, the registrant s financial statements do not reflect 100% of the results of Heritage within the period as Heritage s results for the period from September 1, 2003 through January 19, 2004 (the date of the Energy Transfer Transactions) are not be included. See note 2. The operations of Heritage prior to the Energy Transfer Transactions are referred to as Predecessor Heritage. The assets and liabilities of Predecessor Heritage have been recorded at fair value to the extent acquired by ETC through its acquisition of the General Partner and limited partner interests of Heritage of approximately 35.4%, determined in accordance with Emerging Issues Task Force (EITF) 90-13 *Accounting for Simultaneous Common Control Mergers* and SFAS 141. The assets and liabilities of ETC have been recorded at historical cost. Although the partners capital accounts of ETC became the capital accounts of the Partnership, Predecessor Heritage s partnership structure and partnership units survive. Accordingly, the partners capital accounts of ETC have been restated based on the general partner interests and units received by La Grange

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Energy in the Energy Transfer Transactions. The acquisition of HHI by Heritage was accounted for as a capital transaction as the primary asset held by HHI is 4,426,916 Common Units of Heritage. Following the acquisition of HHI by Heritage, these Common Units were converted to Class E Units. The Class E Units are recorded as treasury units in the unaudited consolidated financial statements.

Costs incurred to construct the Bossier pipeline are recorded at its historical cost. The issuance of the additional Common Units upon the conversion of the Special Units will adjust the percent of Heritage acquired by La Grange Energy in the Energy Transfer Transactions and will result in an additional fair value step-up being recorded in accordance with EITF 90-13. Upon the conversion of the Special Units on June 23, 2004, La Grange Energy acquired approximately 41.5% of Heritage, and approximately $38,000 additional step-up in the fair value of the assets and liabilities of Heritage will be recorded. This does not consider any effects of the TUFCO System transaction or the unit offering that occurred in June 2004.

The excess purchase price over Predecessor Heritage s cost was determined as follows prior to the consideration of the Special Units conversion:

Net book value of Predecessor Heritage at January 20, 2004	$ 238,944
Historical goodwill at January 20, 2004	(170,500)
Equity investment from public offering	355,948
Treasury Class E Unit purchase	(157,340)
	267,052
Percent of Heritage acquired by La Grange Energy	35.4%
Equity interest acquired	$ 94,536
Fair market value of Limited Partner Units	651,170
Purchase price of General Partner Interest	30,000
Equity investment from public offering	355,948
Treasury Class E Unit purchase	(157,340)
	879,778
Percent of Heritage acquired by La Grange Energy	35.4%
Fair value of equity acquired	311,441
Net book value of equity acquired	94,536
Excess purchase price over Predecessor Heritage cost	$ 216,905

The excess purchase price over Predecessor Heritage cost was allocated as follows:	
Property, plant and equipment (25 year life)	$ 34,513
Customer lists (15 year life)	13,641
Trademarks	10,366
Goodwill	158,385
	$ 216,905

The purchase accounting allocations recorded as of May 31, 2004 are preliminary. However, management does not believe there will be material modifications to the purchase price allocations except for the additional allocations resulting from the Special Units conversion to Common Units.

Change of Partnership Name

On February 12, 2004, the Board of Directors of Heritage s General Partner voted to change the name of Heritage to Energy Transfer Partners, L.P., and began trading on the New York Stock Exchange under the ticker symbol ETP . The name change and new ticker symbol were effective March 1, 2004.

Business Operations

In order to simplify the obligations of Energy Transfer Partners, L.P. (the Partnership) under the laws of several jurisdictions in which it conducts business, the Partnership s activities are conducted through two subsidiary operating partnerships, La Grange Acquisition, L.P. (La Grange Acquisition), a Texas limited partnership which is engaged in midstream natural gas operations, and Heritage Operating, L.P. (Heritage Operating), a Delaware limited partnership which is engaged in retail and wholesale propane operations (collectively the Operating Partnerships). The Partnership and the Operating Partnerships are collectively referred to in this report as Energy Transfer.

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La Grange Acquisition owns and operates approximately 6,500 miles of natural gas gathering and transportation pipelines with an aggregate throughput capacity of 2.5 billion cubic feet of natural gas per day, with natural gas treating and processing plants located in Texas, Oklahoma, and Louisiana. Its major asset groups consist of the Southeast Texas System, Elk City System and Oasis pipeline. The Southeast Texas System has a throughput capacity of 720 MMcf/d and includes 2,500 miles of pipeline with 1,050 wells connected, the La Grange processing plant, and 5 natural gas treating facilities. The Elk City System has a throughput capacity of 410 MMcf/d and includes 315 miles of pipeline with 300 wells connected, the Elk City processing plant, and a treating facility. The 583 mile long Oasis pipeline, which connects the West Texas Waha Hub to the Katy Texas tailgate, has a throughput capacity of 750 MMcf/d.

Heritage Operating sells propane and propane-related products to more than 650,000 active residential, commercial, industrial, and agricultural customers in 31 states. Heritage Operating is also a wholesale propane supplier in the United States and in Canada, the latter through its participation in MP Energy Partnership. MP Energy Partnership is a Canadian partnership, in which the Partnership owns a 60% interest, engaged in lower-margin wholesale distribution and in supplying Heritage Operating s northern U.S. locations. Heritage Operating buys and sells financial instruments for its own account through its wholly owned subsidiary, Heritage Energy Resources, L.L.C. (Resources).

The accompanying financial statements should be read in conjunction with the consolidated financial statements of Heritage Propane Partners, L.P. and subsidiaries (Predecessor Heritage) as of August 31, 2003, and the notes thereto included in the registrant s Form 10-K filed with the Securities and Exchange Commission on November 26, 2003, the combined financial statements of ETC as of August 31, 2003, and the notes thereto included in the registrant s Prospectus Supplement on Form 424(b)(2) filed with the Securities and Exchange Commission on January 14, 2004. The accompanying financial statements include only normal recurring accruals and all adjustments that the Partnership considers necessary for a fair presentation. Due to the seasonal nature of the Partnership s propane business, the results of propane operations for interim periods are not necessarily indicative of the results to be expected from these operations for a full year.

2. PRESENTATION OF FINANCIAL INFORMATION:

The accompanying financial statements for the nine months ended May 31, 2004 include the results of operations for ETC for the entire period, consolidated with the results of operations of Heritage Operating and HHI beginning January 20, 2004. The financial statements for the fiscal period including January 20, 2004 do not include the complete results of operations for both ETC and Predecessor Heritage for such periods, as they include the results of operations of Predecessor Heritage only for the period from January 20, 2004 to May 31, 2004. The financial statements of ETC are the financial statements of the registrant, as ETC was deemed the accounting acquiror from the Energy Transfer Transactions. ETC was formed on October 1, 2002, and has an August 31 year-end. ETC s predecessor entities had a December 31 year-end. Accordingly, ETC s 11-month period ended August 31, 2003 was treated as a transition period under the rules of the Securities and Exchange Commission and therefore, only a eight-month period is presented for the period ended May 31, 2003. The accompanying combined financial statements of ETC as of August 31, 2003 and the three and eight months ended May 31, 2003 present the combined financial statements of La Grange Acquisition and subsidiaries after the elimination of significant intercompany balances and transactions.

During the eleven months ended August 31, 2003, ETC owned the Southeast Texas System and the Elk City System. From October 1, 2002 through December 27, 2002, ETC also owned a 50% equity interest in Oasis Pipe Line Company, which owns the Oasis pipeline. After December 27, 2002, ETC owned a 100% interest in Oasis Pipe Line Company. In addition, on December 27, 2002, an affiliate of La Grange Energy s general partner contributed to ETC its marketing business (ET Company I) and its investments in the Vantex System, the Rusk County Gathering System, the Whiskey Bay System and the Chalkley Transmission System.

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The following unaudited pro forma consolidated results of operations are presented as if Oasis Pipe Line Company and ET Company I were wholly owned at the beginning of the periods presented and the Energy Transfer Transactions had been made at the beginning of the periods presented.

	Three Months Ended		Nine Months Ended	Eight Months Ended
	May 31, 2004	May 31, 2003	May 31, 2004	May 31, 2003
	(actual)	(pro forma)	(pro forma)	(pro forma)
REVENUES:				
Midstream and transportation	$ 505,691	$ 372,535	$ 1,408,968	$ 703,346
Affiliated midstream		51		5,117
Propane Operations	122,850	113,040	497,358	441,358
Other	13,634	12,700	51,513	47,649
Total revenues	642,175	498,326	1,957,839	1,197,470
COSTS AND EXPENSES:				
Cost of products sold	530,130	396,431	1,590,915	867,522
Operating expenses	52,695	49,336	152,686	137,077
Depreciation and amortization	16,489	15,032	47,516	40,872
Selling, general and administrative	10,026	8,410	31,318	22,206
Realized and unrealized (gains) losses on derivatives	(3,352)	(1,367)	(13,554)	5,219
Total costs and expenses	605,988	467,842	1,808,881	1,072,896
OPERATING INCOME	36,187	30,484	148,958	124,574
OTHER INCOME (EXPENSE)				
Interest, net	(12,234)	(14,390)	(40,459)	(40,913)
Equity in earnings of affiliates	179	552	1,002	1,606
Gain loss on disposal of assets	(263)	(3)	(235)	
Other	(103)	(89)	65	(581)
INCOME BEFORE MINORITY INTERESTS AND INCOME TAXES	23,766	16,554	109,331	84,686
Minority interests	(67)	(111)	(583)	(536)
INCOME BEFORE INCOME TAXES	23,699	16,443	108,748	84,150
Income Taxes	2,369	2,458	6,763	7,351

NET INCOME	21,330	13,985	101,985	76,799
GENERAL PARTNER S INTEREST IN NET INCOME	2,698	976	6,327	3,559
LIMITED PARTNERS INTEREST IN NET INCOME	$ 18,632	$ 13,009	$ 95,658	$ 73,240
BASIC EARNINGS PER LIMITED PARTNER UNIT	$ 0.52	$ 0.39	$ 2.70	$ 2.20
BASIC AVERAGE NUMBER OF UNITS OUTSTANDING	35,637,406	33,704,274	35,410,697	33,335,471
DILUTED EARNINGS PER LIMITED PARTNER UNIT	$ 0.52	$ 0.39	$ 2.70	$ 2.20
DILUTED AVERAGE NUMBER OF UNITS OUTSTANDING	35,665,702	33,728,774	35,437,262	33,359,971

	Three Months Ended May 31, 2004	Three Months Ended May 31, 2003	Nine Months Ended May 31, 2004	Eight Months Ended May 31, 2003
	(actual)	(pro forma)	(pro forma)	(pro forma)
VOLUMES				
Midstream				
Natural gas MMBtu/d	867,000	611,000	919,000	487,000
NGLs bbls/d	10,600	7,400	12,700	10,500
Transportation				
Natural gas MMBtu/d	1,043,000	930,000	902,000	874,000
Propane operations (in gallons)				
Retail propane	81,663	77,997	337,751	321,340
Domestic wholesale	2,533	2,337	9,205	12,694
Foreign wholesale	10,461	10,518	45,636	53,071

The pro forma consolidated results of operations include adjustments to give effect to depreciation on the step-up of property, plant and equipment, amortization of customer lists, interest expense on acquisition debt, and certain other adjustments. The unaudited pro forma information is not necessarily indicative of the results of operations that would have occurred had the transactions been made at the beginning of the periods presented or the future results of the combined operations.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND BALANCE SHEET DETAIL:

Principles of Consolidation

Prior to the merger with Heritage, Energy Transfer Company was the assumed name of a group of entities under common control consisting of La Grange Acquisition, L.P. and a series of its limited partner investees. La Grange Acquisition is a Texas limited partnership formed on October 1, 2002 and was 99.9% owned by its limited partner, La Grange Energy, L.P., and 0.1% owned by its general partner, LA GP, LLC. La Grange Acquisition is the 99.9% limited partner of ETC Gas Company, Ltd., ETC Texas Pipeline, Ltd., ETC Processing, Ltd., ETC Oklahoma Pipeline, Ltd., ETC Katy Pipeline, Ltd., and ETC Marketing, Ltd. and a 99% limited partner of ETC Oasis, L.P. and ET Company I, Ltd. (collectively, the Operating Companies). The general partners of La Grange Acquisition, La Grange Energy, and the Operating Companies were ultimately owned and controlled by members of management, a private equity investor fund, and a group of institutional investors. La Grange Acquisition and the Operating Companies conducted business under the name Energy Transfer Company. The historical financial statements of Energy Transfer Company present the accounts of La Grange Acquisition and the Operating Companies (collectively Energy Transfer Company or ETC) on a combined basis as entities under common control. The accompanying combined financial statements of ETC as of August 31, 2003 and the three and eight months ended May 31, 2003, include the accounts of La Grange Acquisition and the Operating Companies after the elimination of significant intercompany balances and transactions. Further, La Grange Acquisition s limited partner investments in each of the Operating Companies were eliminated against the Operating Companies limited partner s capital. From October 2002 through December 2002, ETC owned a 20% interest in the Nustar Joint Venture. Effective December 27, 2002, ETC owned a 50% interest in Vantex Gas Pipeline Company, LLC, and a 49.5% interest in Vantex Energy Services, Ltd. These investments are accounted for under the equity method. All significant intercompany transactions have been eliminated. Prior to December 27, 2002, when the remaining 50% of Oasis Pipe Line Company (Oasis) capital stock was redeemed, ETC accounted for its 50% ownership in Oasis under the equity method. After December 27, 2002, Oasis became a wholly owned subsidiary of ETC. La Grange Acquisition and the Operating Companies were contributed by La Grange Energy to Heritage and, thus, after the January 2004 Energy Transfer Transactions, La Grange Acquisition, L.P. and the Operating Companies under La Grange Acquisition, became wholly owned subsidiaries of the Partnership.

Predecessor Heritage s financial statements include the accounts of its subsidiaries, including Heritage Operating and its subsidiaries. At August 31, 2003, Predecessor Heritage accounted for its 50% partnership interest in Bi-State Propane, (Bi-State) a propane retailer in the states of Nevada and California, under the equity method. On December 24, 2003, Predecessor Heritage acquired the remaining 50% of Bi-State that it did not previously own, thereby making Bi-State a wholly owned subsidiary of Predecessor Heritage.

After the Energy Transfer Transactions, the consolidated financial statements of the registrant include the accounts of its subsidiaries, including the Operating Partnerships and HHI. A minority interest liability and minority interest expense is recorded for all partially owned subsidiaries. All significant intercompany transactions and accounts have been eliminated in consolidation. In the opinion of management, all adjustments (which are normal and recurring) have been made which are necessary to fairly state the consolidated financial statements of Energy Transfer Partners, L.P. and subsidiaries for all interim periods presented.

For purposes of maintaining partner capital accounts, the Partnership Agreement of Energy Transfer Partners, L.P. (the Partnership Agreement) specifies that items of income and loss shall generally be allocated among the partners in accordance with their percentage interests (see footnote 8). Normal allocations according to percentage interests are made, however, only after giving effect to any priority income allocations in an amount equal to the incentive distributions that are allocated 100% to the General Partner.

Revenue Recognition

Revenues for sales of natural gas, natural gas liquids (NGLs) including propane, and propane appliances, parts, and fittings are recognized at the later of the time of delivery of the product to the customer or the time of sale or installation. Revenue from service labor, transportation, treating, compression, and gas processing, is recognized upon completion of the service. Transportation capacity payments are recognized when earned in the period the capacity was made available. Tank rent is recognized ratably over the period it is earned.

Shipping and Handling Costs

In accordance with the Emerging Issues Task Force Issue 00-10, *Accounting for Shipping and Handling Fees and Costs,* the Partnership has classified all deductions from producer payments for natural gas, compression and treating, which can be considered handling costs, as revenue. The Partnership does not separately charge shipping and handling costs of propane to customers.

Costs and Expenses

Costs of products sold include actual cost of fuel sold adjusted for the effects of qualifying cash flow hedges, storage fees and inbound freight on propane, and the cost of appliances, parts, and fittings. Operating expenses include all costs incurred to provide products to customers, including compensation for operations personnel, insurance costs, vehicle maintenance, advertising costs, shipping and handling costs related to propane, purchasing costs, and plant operations. Selling, general and administrative expenses include all corporate expenses and compensation for corporate personnel.

Cash and Cash Equivalents

Cash and cash equivalents include all cash on hand, demand deposits, and investments with original maturities of three months or less. The Partnership considers cash equivalents to include short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Marketable Securities

Marketable securities owned by the Partnership are classified as available-for-sale securities and are reflected as a current asset on the consolidated balance sheet at their fair value. Unrealized holding gains of $520 and $141 for the three and nine months ended May 31, 2004, and $0 for the three and eight months ended May 31, 2003, respectively, and unrealized holding losses of $253 and $262 for the three and nine months ended May 31, 2003, respectively for Predecessor Heritage were recorded through accumulated other comprehensive income (loss) based on the market value of the securities.

Accounts Receivable

The Partnership s midstream and transportation operations deal with counterparties that are typically either investment grade or are otherwise secured with a letter of credit or other form of security (corporate guaranty or prepayment). Management reviews midstream and transportation accounts receivable balances each week. Credit limits are assigned and monitored for all counterparties of the midstream and transportation operations. Bad debt expense related to these receivables is recognized at the time an account is deemed uncollectible.

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The Partnership grants credit to its customers for the purchase of propane and propane-related products. Also included in accounts receivable are trade accounts receivable arising from the Partnership s retail and wholesale propane operations and receivables arising from Resources liquids marketing activities. Accounts receivable for retail and wholesale propane and liquids marketing activities are recorded as amounts billed to customers less an allowance for doubtful accounts. The allowance for doubtful accounts is based on management s assessment of the realizability of customer accounts. Management s assessment is based on the overall creditworthiness of the Partnership s customers and any specific disputes. Accounts receivable consisted of the following:

	May 31, 2004	August 31, 2003	August 31, 2003
		(Energy Transfer Company)	(Predecessor Heritage)
Accounts receivable midstream and transportation	$185,789	$ 105,987	$
Accounts receivable propane	49,279		39,383
Less allowance for doubtful accounts	996		3,504
Total, net	$234,072	$ 105,987	$ 35,879

The activity in the allowance for doubtful accounts consisted of the following:

	Nine Months Ended May 31, 2004	Eight Months Ended May 31, 2003	Nine Months Ended May 31, 2003
		(Energy Transfer Company)	(Predecessor Heritage)
Balance, beginning of the period	$	$	$ 2,504
Provision for loss on accounts receivable	996		1,978
Accounts receivable written off, net of recoveries			(978)
Balance, end of period	$ 996	$	$ 3,504

Inventories

Inventories are valued at the lower of cost or market. The cost of propane inventories is determined using weighted-average cost of propane delivered to the customer service locations, and includes storage fees and inbound freight costs, while the cost of appliances, parts, and fittings is determined by the first-in, first-out method. Inventories consisted of the following:

	May 31, 2004	August 31, 2003	August 31, 2003
		(Energy Transfer Company)	(Predecessor Heritage)
Propane and other NGLs	$26,497	$ 1,876	$34,544
Appliances, parts and fittings and other	11,930	2,071	10,730
Total inventories	$38,427	$ 3,947	$45,274

Deposits

Deposits are paid to vendors in the midstream and transportation business as prepayments for natural gas deliveries in the following month. The Partnership makes prepayments when the volume of business with a vendor exceeds the Partnership s credit limit and/or when it is economically beneficial to do so. Deposits with vendors for gas purchases were $0 and $16,962 as of May 31, 2004 and August 31, 2003, respectively. The Partnership also has deposits with derivative counterparties of $1,547 and $2,091 as of May 31, 2004 and August 31, 2003, respectively.

Deposits are received from midstream and transportation customers as prepayments for natural gas deliveries in the following month and deposits from propane customers as security for future propane use. Prepayments and security deposits may also be required when customers exceed their credit limits or do not qualify for open credit. Deposits

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received from customers were $10,356 and $11,600 as of May 31, 2004 and August 31, 2003, respectively and are recorded as accrued and other current liabilities on the Partnership s consolidated balance sheets. Predecessor Heritage s deposits received from customers were $2,137 as of August 31, 2003.

Exchanges

Exchanges consist of natural gas and NGL delivery imbalances with others. These amounts turn over monthly and management believes the cost approximates market value. Accordingly, these volumes are valued at market prices and are recorded as exchanges receivable or exchanges payable on the Partnership s consolidated balance sheets.

Property, Plant and Equipment

Property, plant and equipment is stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Expenditures for maintenance and repairs that do not add capacity or extend the useful life are expensed as incurred. Expenditures to refurbish assets that either extend the useful lives of the asset or prevent environmental contamination are capitalized and depreciated over the remaining useful life of the asset. Additionally, the Partnership capitalizes certain costs directly related to the installation of company-owned propane tanks and construction of assets including internal labor costs, interest and engineering costs. Upon disposition or retirement of pipeline components or natural 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.

The Partnership reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. If such a review should indicate that the carrying amount of long-lived assets is not recoverable, the Partnership reduces the carrying amount of such assets to fair value. No impairment of long-lived assets was recorded during the periods presented.

Components and useful lives of property, plant and equipment were as follows:

	May 31, 2004	August 31, 2003	August 31, 2003
		(Energy Transfer Company)	(Predecessor Heritage)
Land and improvements	$ 26,627	$ 992	$ 21,937
Buildings and improvements (10 to 30 years)	31,155	987	30,843
Pipelines and equipment (10 to 65 years)	403,173	382,517	
Bulk storage, equipment and facilities (3 to 30 years)	48,157		43,340
Tanks and other equipment (5 to 30 years)	320,316		327,193
Vehicles (5 to 10 years)	51,603		76,239
Right of way (20 to 65 years)	5,003	4,057	
Furniture and fixtures (3 to 10 years)	6,885		11,164
Linepack	5,176	5,176	
Other (5 to 10 years)	4,382	3,675	3,578

	902,477	397,404	514,294
Less Accumulated depreciation	(39,195)	(13,261)	(99,563)
	863,282	384,143	414,731
Plus Construction work-in-process	94,596	7,121	11,857
Property, plant and equipment, net	$957,878	$391,264	$426,588

Capitalized interest is included for pipeline construction projects. Interest is capitalized based on the current borrowing rate. As of May 31, 2004 a total of $717 thousand has been capitalized for the Bossier pipeline construction.

The Partnership accounts for expected future costs associated with its obligation to perform site reclamation and dismantle facilities of abandoned pipelines under Statement of Accounting Standards No. 143, *Accounting for Asset Retirement Obligations,* (SFAS 143). If a reasonable estimate of the fair value of an abandonment obligation can be made, SFAS 143 requires the Partnership to record a liability (an asset retirement obligation or ARO) on the consolidated balance sheets in other non-current liabilities and to capitalize the asset retirement cost in the period in which the retirement obligation is incurred. In general, the amount of an ARO and the associated costs capitalized will be equal to the estimated future cost to satisfy the abandonment obligation using current prices after discounting the future cost back to the date that the abandonment obligation was incurred using the credit-adjusted risk-free rate for the Partnership. After recording these amounts, the ARO will be accreted to its future estimated value using the credit-adjusted risk-free rate and the additional capitalized costs will be depreciated on a straight line basis over the productive life of the related assets. The Partnership had an ARO of approximately $3,672 recorded in the consolidated balance sheet as of May 31, 2004. The Partnership acquired all of its operating assets subsequent to the effective date of SFAS 143; therefore there is no cumulative effect of adopting SFAS 143.

No assets are legally restricted for purposes of settling the Partnership s AROs. A reconciliation of the beginning and ending aggregate carrying amount of the Partnership s ARO for the nine months ended May 31, 2004 is as follows:

Balance as of August 31, 2003	$
Liabilities incurred	3,500
Liabilities settled	
Accretion expense	172
Revision in estimated abandonment costs	
Balance as of May 31, 2004	$3,672

Intangibles and Other Assets

Intangibles and other assets are stated at cost net of amortization computed on the straight-line method. The Partnership eliminates from its balance sheet any fully amortized intangibles and the related accumulated amortization. Components and useful lives of intangibles and other assets were as follows:

	May 31, 2004		**August 31, 2003**		**August 31, 2003**	
	Gross Carrying Amount	**Accumulated Amortization**	**Gross Carrying Amount**	**Accumulated Amortization**	**Gross Carrying Amount**	**Accumulated Amortization**
			(Energy Transfer Company)		**(Predecessor Heritage)**	
Amortized intangible assets -						
Noncompete agreements (5 to 15 years)	$ 27,866	$ (1,735)	$	$	$42,742	$(15,893)
Customer lists (15 years)	41,404	(1,358)			28,378	(6,356)
Financing costs (3 to 15 years)	14,124	(5,061)	5,724	(2,464)	4,225	(1,995)
Consulting agreements (2	132	(17)			517	(367)

to 7 years)						
Other (10 years)	477	(131)	477	(92)		
Total	84,003	(8,302)	6,201	(2,556)	75,862	(24,611)
Unamortized intangible assets -						
Trademarks	17,827				1,309	
Other assets	2,358		1,761		264	
Total intangibles and other assets	$104,188	$ (8,302)	$ 7,962	$ (2,556)	$77,435	$(24,611)

Aggregate amortization expense of intangible assets was $1,113 and $3,740 for the three and nine months ended May 31, 2004, respectively and, $858 and $1,885 for the three and eight months ended May 31, 2003, respectively. Predecessor Heritage s aggregate amortization expense was $1,858 and $5,804 for the three and nine months ended May 31, 2003, respectively.

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Goodwill

Goodwill is associated with acquisitions made for the Partnership s midstream and retail propane segments. There is no goodwill associated with the transportation segment. Of the $290,624 balance in goodwill, $20,690 is expected to be tax deductible. Goodwill is tested for impairment annually in accordance with Statement of Accounting Standards No. 142, *Goodwill and Other Intangible Assets,* (SFAS 142). The changes in the carrying amount of goodwill for the nine months ended May 31, 2004 were as follows:

	Midstream	Retail Propane	Total
Balance as of August 31, 2003	$13,409	$	$ 13,409
Goodwill acquired during the year		277,215	277,215
Impairment losses			
Balance as of May 31, 2004	$13,409	$277,215	$290,624

Accrued and Other Current Liabilities

Accrued and other current liabilities consisted of the following:

	May 31, 2004	August 31, 2003	August 31, 2003
		(Energy Transfer Company)	(Predecessor Heritage)
Interest payable	$ 6,968	$ 1,014	$ 4,485
Wages, payroll taxes and employee benefits	14,691	2,702	4,932
Deferred tank rent	4,532		4,080
Customer deposits	10,356	11,600	2,137
Taxes other than income	4,693	2,460	2,405
Environmental	504	633	
Advanced budget payments and unearned revenue	1,961		15,417
Other	3,710	1,246	2,117
Accrued and other current liabilities	$47,415	$ 19,655	$ 35,573

Income Taxes

Energy Transfer Partners is a limited partnership. As a result, The Partnership s earnings or losses for federal and state income tax purposes are included in the tax returns of the individual partners. Net earnings for financial statement purposes may differ significantly from taxable income reportable to unitholders as a result of differences between the tax basis and financial reporting basis of assets and liabilities and the taxable income allocation requirements under the Partnership Agreement.

Oasis, HHI and certain other of the Partnership s subsidiaries are taxable corporations and follow the liability method of accounting for income taxes in accordance with Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* (SFAS 109). Under SFAS 109, deferred income taxes are recorded based upon differences between the financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the underlying assets are received and liabilities settled.

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Income Per Limited Partner Unit

Basic net income (loss) per limited partner unit is computed by dividing net income (loss), after considering the General Partner s interest, by the weighted average number of Common and Class D Units outstanding. Diluted net income (loss) per limited partner unit is computed by dividing net income (loss), after considering the General Partner s interest, by the weighted average number of Common and Class D Units outstanding and the weighted average number of restricted units (Phantom Units) granted under the Restricted Unit Plan. A reconciliation of net income (loss) and weighted average units used in computing basic and diluted net income (loss) per unit is as follows:

	Three Months Ended May 31, 2004	Three Months Ended May 31, 2003	Three Months Ended May 31, 2003	Nine Months Ended May 31, 2004	Eight Months Ended May 31, 2003	Nine Months Ended May 31, 2003
		(Energy Transfer Company)	(Predecessor Heritage)		(Energy Transfer Company)	(Predecessor Heritage)
Basic Net Income per Limited Partner Unit:						
Limited Partners interest in net income (loss)	$ 18,633	$ 18,450	$ (2,391)	$ 80,947	$ 29,786	$ 47,909
Weighted average limited partner units	35,637,406	6,621,737	16,574,582	20,703,273	6,621,737	16,189,029
Basic net income per limited partner unit	$ 0.52	$ 2.79	$ (0.14)	$ 3.91	$ 4.50	$ 2.96
Diluted Net Income per Limited Partner Unit:						
Limited partners interest in net income (loss)	$ 18,633	$ 18,450	$ (2,391)	$ 80,947	$ 29,786	$ 47,909
	35,637,406	6,621,737	16,574,582	20,703,273	6,621,737	16,189,029

Weighted average limited partner units Dilutive effect of phantom units	28,296			26,564		38,032
Weighted average limited partner units, assuming dilutive effect of phantom units	35,665,702	6,621,737	16,574,582	20,729,837	6,621,737	16,227,061
Diluted net income (loss) per limited partner unit	$ 0.52	$ 2.79	$ (0.14)	$ 3.90	$ 4.50	$ 2.95

Stock Based Compensation Plans

The Partnership follows the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 *Accounting for Stock-based Compensation* (SFAS 123).

Restricted Unit Plan

The General Partner has adopted the Amended and Restated Restricted Unit Plan dated August 10, 2000, amended February 4, 2002 as the Second Amended and Restated Restricted Unit Plan (the Restricted Unit Plan), for certain directors and key employees of the General Partner and its affiliates. The Restricted Unit Plan covers rights to acquire 146,000 Common Units. The right to acquire the Common Units under the Restricted Unit Plan, including any forfeiture or lapse of rights is available for grant to key employees on such terms and conditions (including vesting conditions) as the Compensation Committee of the General Partner shall determine. Each director who is not a member of management or an owner of the General Partner automatically receives a Director s grant with respect to 500 Common Units on each September 1 that such person continues as a director. Newly elected directors who are not members of management or an owner of the General Partner are also entitled to receive a grant with respect to 2,000 Common Units upon election or appointment to the Board. Generally, the rights to acquire the Common Units will vest upon the later to occur of the three-year anniversary of the grant date, or on such terms as the Compensation Committee may establish, which may include the achievement of performance objectives. In the event of a change of control (as defined in the Restricted Unit Plan), all rights to acquire Common Units pursuant to the Restricted Unit Plan will immediately vest.

Pursuant to the Energy Transfer Transactions, the change of control provisions of the Restricted Unit Plan were triggered, resulting in the early vesting of 21,600 units by Predecessor Heritage. Individuals holding 4,500 grants waived their rights to early vesting under the change of control provisions. Compensation expense on the units that vested was recognized by Predecessor Heritage.

The issuance of the Common Units pursuant to the Restricted Unit Plan is intended to serve as a means of incentive compensation for performance and not primarily as an opportunity to participate in the equity appreciation in respect of the Common Units. Therefore, no consideration will be payable by the plan participants upon vesting and issuance of the Common Units. As of May 31, 2004, 8,296 restricted units were outstanding and 10,504 were available for grants to non-employee directors and key employees. There was no deferred compensation expense recognized for the three and nine months ended May 31, 2004, or for the three and eight months ended May 31, 2003. Predecessor Heritage recognized $81 and $243 deferred compensation expense for the three and nine months ended May 31, 2003, respectively.

Long-Term Incentive Plan

Effective September 1, 2000, Predecessor Heritage adopted a long-term incentive plan whereby Common Units were awarded based on achieving certain targeted levels of Distributed Cash (as defined in the Long Term Incentive Plan) per unit. Awards under the program were made starting in 2003 based upon the average of the prior three years Distributed Cash per unit. A minimum of 250,000 Common Units and if certain targeted levels are achieved, a maximum of 500,000 Common Units will be awarded.

In connection with the Energy Transfer Transactions, the change of control provisions in each of the employment agreements of the participants in the plan triggered the minimum award, less any amounts previously earned and any amounts that had not been designated for award, resulting in the issuance of 150,018 units by Predecessor Heritage. Compensation expense on the units that vested was recognized by Predecessor Heritage and no deferred compensation expense was recognized for the three and nine months ended May 31, 2004, or the three and eight months ended May 31, 2003. Predecessor Heritage recognized deferred compensation expense of $228 and $686 for the three and nine months ended May 31, 2004, respectively

2004 Unit Plan

On June 23, 2004 at a special meeting of the Common Unitholders, the 2004 Unit Plan (the Plan) was approved. The Plan provides for the award of Common Units and other rights to the Partnership s employees, and officers and to directors who are not members of management or owners of the General Partner. The Unit Plan will be administered by the Compensation Committee of the Board of Directors of the Partnership s General Partner. The Compensation Committee shall have discretion with respect to awards under the 2004 Unit Plan. The Unit Plan provides for a maximum of 900,000 net Common Units issued available for grants pursuant to its terms. Any Awards that are forfeited or expire, or any units that are not used in the settlement of an Award will again be available for grant under the plan. The Unit Plan will terminate no later than the tenth anniversary of the date of its approval. Units to be delivered upon the vesting of an Award may be (i) units acquired by the General Partner of the Partnership in the open market, (ii) units already owned by the General Partner of the Partnership, (iii) units acquired by the General Partner directly from the Partnership, or any other person, (iv) units that are registered under a registration statement for the Unit Plan, (v) restricted units, or (vi) any combination of the foregoing. The Compensation Committee shall have the discretion at the time of granting an Award, or at the time an Award vests, to determine whether a participant receives units or a cash payment in lieu of units, or any combination thereof. The exercise of any options or Unit Appreciation

Rights granted under the plan shall be in accordance with the terms and at such price as may be determined by the Compensation Committee. Any Awards granted under the Unit Plan are not transferable by the recipient except by will or the laws of descent and distribution or to a trust for the benefit of such participant or their immediate family. There are currently no grants under the 2004 Unit Plan.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The natural gas industry conducts its business by processing actual transactions at the end of the month following the month of delivery. Consequently, the most current month s financial results for the midstream and transportation segments are estimated using volume estimates and market prices. Any difference between estimated results and actual results are recognized in the following month s financial statements. Management believes that the profitability estimated for the period ending May 2004 represents the actual results in all material respects.

Some of the other more significant estimates made by management include, but are not limited to, allowances for doubtful accounts, the fair value of derivative instruments, useful lives for depreciation and amortization, purchase accounting allocations and subsequent realizability of intangible assets, the amount of the Partnership s ARO and general business and medical self-insurance reserves. Actual results could differ from those estimates.

Reclassifications

Certain prior period amounts have been reclassified to conform with the 2004 presentation. These reclassifications have no impact on net income or total partners capital.

Accounting for Derivative Instruments and Hedging Activities

The Partnership applies Financial Accounting Standards Board Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133) as amended. This statement requires that all derivatives be recognized in the balance sheet as either an asset or liability measured at fair value. Special accounting for qualifying hedges allows a derivative s gains and losses to offset related results on the hedged item in the statement of operations and requires that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting treatment.

The Partnership 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. Generally, management has previously elected not to apply hedge accounting to these contracts, therefore, the net gain or loss arising from marking to market these derivative instruments was previously recognized in earnings as unrealized gains and losses on the statement of operations. However, in the nine months ended May 31, 2004, the Partnership designated various new futures and certain associated basis contracts as cash flow hedging instruments in accordance with SFAS 133. The effective portion of the hedge gain or loss is initially reported as a component of other comprehensive income and is subsequently reclassified into earnings when the instrument settles. The ineffective portion of the gain or loss is reported in earnings immediately. As of May 31, 2004, these instruments had a net fair value of $2,149, which was recorded as price risk management assets and liabilities on the balance sheet through other comprehensive income. The Partnership reclassified into earnings gains of $3,063 and losses of $1,776 for the three and nine months ended May 31, 2004 related to the commodity financial instruments, respectively, that were previously reported in accumulated other comprehensive income (loss). The amount of hedge ineffectiveness recognized in income was a gain of $167 and $125 for the three and nine months ended May 31, 2004, respectively. There were no financial instruments designated as hedges for the three and eight months ended May 31, 2003.

The Partnership also entered into an interest rate swap agreement for the purpose of mitigating the interest rate risk associated with the La Grange Acquisition Term Note. The interest rate swap agreement is used to manage a portion of the exposure to changing interest rates by converting floating rate debt to fixed rate debt. The fair value of the swap was a liability of $542 and $807 as of May 31, 2004 and August 31, 2003, respectively which is recorded as price risk management liabilities on the balance sheet. The Partnership reclassified into earnings through interest expense, losses of $297 and $1,358 for the three and nine months ended May 31, 2004 that were previously reported in accumulated other comprehensive income (loss).

In the course of normal operations, the Partnership routinely enters into contracts such as forward physical contracts for the purchase and sale of natural gas, propane, and other NGLs that qualify for and are designated as a normal purchase and sales contracts. Such contracts are exempted from the fair value accounting requirements of SFAS 133 and are accounted for using traditional accrual accounting.

The market prices used to value the financial derivative transactions 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 are adjusted to reflect the potential impact of liquidating a position in an orderly manner over a reasonable period of time under present market conditions.

Recently Issued Accounting Standards

In May 2003, the FASB issued Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (SFAS 150). SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within the scope of SFAS 150 as a liability (or an asset in some circumstances). This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Partnership adopted the provisions of SFAS 150 as of September 1, 2003. The adoption did not have a material impact on the Partnership s consolidated financial position or results of operations.

In January 2003, the Financial Accounting Standards Board issued Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46). The interpretation was revised in December 2003. As revised, FIN 46 addresses consolidation of business enterprise of variable interest entities. FIN 46 was effective immediately for all variable interest entities created after January 31, 2003 and for the first fiscal year or interim period ending after March 15, 2004 for variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. The implementation of FIN 46 did not have a significant impact on the Partnership s financial position or results of operations.

4. MATERIAL ACQUISITIONS:

In October 2002, La Grange Acquisition purchased certain operating assets from Aquila Gas Pipeline, primarily natural gas gathering, treating and processing assets in Texas and Oklahoma. The assets acquired and purchase price allocation were as follows:

Materials and supplies	$ 1,626
Other assets	194
Property, plant and equipment	213,374
Investment in Oasis	41,670
Investment in Nustar Joint Venture	9,600
Accrued expenses	(2,788)
Total	$263,676

At the closing of the acquisition of Aquila Gas Pipeline s assets, $5,000 was put into escrow until such time that proper consents and conveyance could be achieved related to a sales contract. It was later determined that it was unlikely that a proper conveyance could be achieved which resulted in the escrowed amount of $5,000 being returned to La Grange

Acquisition during the period ended August 31, 2003. The return of the $5,000 purchase price reduced La Grange Acquisition s basis in property, plant and equipment.

On December 27, 2002, Oasis Pipe Line Company redeemed the remaining 50% of its capital stock owned by Dow Hydrocarbons Resources, Inc. for $87,000, and cancelled the stock. La Grange Acquisition, L.P. now owns 100% of the capital stock of Oasis Pipe Line Company.

Also, on December 27, 2002, ETC Holdings, LP, a limited partner of La Grange Energy, contributed ET Company I to the Partnership. The investment in the Vantex system was included in the assets contributed.

5. WORKING CAPITAL FACILITY AND LONG-TERM DEBT:

Long-term debt consists of the following:

	May 31, 2004	August 31, 2003 (Energy Transfer Company)	August 31, 2003 (Predecessor Heritage)
1996 8.55% Senior Secured Notes	$ 96,000	$	$ 96,000
1997 Medium Term Note Program:			
7.17% Series A Senior Secured Notes	12,000		12,000
7.26% Series B Senior Secured Notes	18,000		20,000
6.50% Series C Senior Secured Notes	1,786		2,143
2000 and 2001 Senior Secured Promissory Notes:			
8.47% Series A Senior Secured Notes	12,800		16,000
8.55% Series B Senior Secured Notes	32,000		32,000
8.59% Series C Senior Secured Notes	27,000		27,000
8.67% Series D Senior Secured Notes	58,000		58,000
8.75% Series E Senior Secured Notes	7,000		7,000
8.87% Series F Senior Secured Notes	40,000		40,000
7.21% Series G Senior Secured Notes	15,200		19,000
7.89% Series H Senior Secured Notes	8,000		8,000
7.99% Series I Senior Secured Notes	16,000		16,000
Term Loan Facility	325,000	226,000	
Senior Revolving Acquisition Facility	39,228		24,700
Notes Payable on noncompete agreements with interest imputed at rates averaging 7.38%, due in installments through 2010	19,066		20,110
Other	1,636		1,118
Current maturities of long-term debt	(30,785)	(30,000)	(38,309)
	$697,931	$ 196,000	$360,762

Maturities of the Senior Secured Notes, the Medium Term Note Program and the Senior Secured Promissory Notes (the Notes) are as follows:

1996 8.55% Senior Secured Notes:

mature at the rate of $12,000 on June 30 in each of the years 2002 to and including 2011. Interest is paid semi-annually.

1997 Medium Term Note Program:

Series A Notes:	mature at the rate of $2,400 on November 19 in each of the years 2005 to and including 2009. Interest is paid semi-annually.
Series B Notes:	mature at the rate of $2,000 on November 19 in each of the years 2003 to and including 2012. Interest is paid semi-annually.

Series C Notes:	mature at the rate of $714 on March 13 in each of the years 2000 to and including 2003, $357 on March 13, 2004, $1,073 on March 13, 2005, and $357 in each of the years 2006 and 2007. Interest is paid semi-annually.

2000 and 2001 Senior Secured Promissory Notes:

Series A Notes:	mature at the rate of $3,200 on August 15 in each of the years 2003 to and including 2007. Interest is paid quarterly.
Series B Notes:	mature at the rate of $4,571 on August 15 in each of the years 2004 to and including 2010. Interest is paid quarterly.
Series C Notes:	mature at the rate of $5,750 on August 15 in each of the years 2006 to and including 2007, $4,000 on August 15, 2008 and $5,750 on August 15, 2009 to and including 2010. Interest is paid quarterly.
Series D Notes:	mature at the rate of $12,450 on August 15 in each of the years 2008 and 2009, $7,700 on August 15, 2010, $12,450 on August 15, 2011 and $12,950 on August 15, 2012. Interest is paid quarterly.
Series E Notes:	mature at the rate of $1,000 on August 15 in each of the years 2009 to and including 2015. Interest is paid quarterly.
Series F Notes:	mature at the rate of $3,636 on August 15 in each of the years 2010 to and including 2020. Interest is paid quarterly.
Series G Notes:	mature at the rate of $3,800 on May 15 in each of the years 2004 to and including 2008. Interest is paid quarterly. $7.5 million of these notes were retired during the fiscal year ended August 31, 2003.
Series H Notes:	mature at the rate of $727 on May 15 in each of the years 2006 to and including 2016. Interest is paid quarterly. $19.5 million of these notes were retired during the fiscal year ended August 31, 2003.
Series I Notes:	mature in one payment of $16,000 on May 15, 2013. Interest is paid quarterly.

All receivables, contracts, equipment, inventory, general intangibles, cash concentration accounts, and the capital stock of Heritage Operating and its subsidiaries secure the Senior Secured, Medium Term, and Senior Secured Promissory Notes. In addition to the stated interest rate for the Notes, the Partnership is required to pay an additional 1% per annum on the outstanding balance of the Notes at such time as the Notes are not rated investment grade status or higher. On April 18, 2004 the Notes were rated investment grade or better thereby alleviating the requirement that Heritage Operating pay the additional 1% interest.

Effective January 20, 2004, La Grange Acquisition entered into the Second Amended and Restated Credit Agreement. The terms of the Agreement are as follows:

A $325,000 Term Loan Facility that matures on January 18, 2008. Amounts borrowed under the La Grange Acquisition Credit Facility bear interest at a rate based on either a Eurodollar rate, or a prime rate. The weighted average interest rate was 3.38% at May 31, 2004. The Term Loan Facility is secured by substantially all of the La

Grange Acquisition s assets. On June 1, 2004, the Term Loan Facility was amended to increase the borrowing capacity from $325,000 to $725,000. An additional $400,000 was borrowed on June 2, 2004 to partially finance the purchase of the midstream natural gas assets of TXU Fuel Company.

A $175,000 Revolving Credit Facility is available through January 18, 2008. Amounts borrowed under the La Grange Acquisition Credit Facility bear interest at a rate based on either a Eurodollar rate, or a prime rate. The maximum commitment fee payable on the unused portion of the facility is 0.50%. The facility is fully secured by substantially all of La Grange Acquisition s assets. As of May 31, 2004, there were no amounts outstanding under the Revolving Credit Facility, and $17,200 in letters of credit outstanding which reduce the amount available for borrowing under the Revolving Credit Facility. Letters of Credit under the Revolving Credit Facility may not exceed $40,000. On June 1, 2004, the Revolving Credit Facility was amended to increase the borrowing capacity from $175,000 to $225,000. On June 2, 2004, La Grange Acquisition borrowed $105,000 under the Revolving Credit Facility to partially finance the purchase of the midstream natural gas assets of TXU Fuel Company. On July 6, 2004, La Grange Acquisition repaid the amount borrowed on the Revolving Credit Facility, using proceeds from a June 30, 2004 Equity Offering of the Partnership.

Effective March 31, 2004, Heritage Operating entered into the Third Amended and Restated Credit Agreement. The terms of the Agreement are as follows:

A $75,000 Senior Revolving Working Capital Facility is available through December 31, 2006. Amounts borrowed under the Working Capital Facility bear interest at a rate based on either a Eurodollar rate or a prime rate. The weighted average interest rate was 2.7250% for the amount outstanding at May 31, 2004. The maximum commitment fee payable on the unused portion of the facility is 0.50%. Heritage Operating must reduce the principal amount of working capital borrowings to $10,000 for a period of not less than 30 consecutive days at least one time during each fiscal year. All receivables, contracts, equipment, inventory, general intangibles, cash concentration accounts, and the capital stock of Heritage Operating s subsidiaries secure the Senior Revolving Working Capital Facility. As of May 31, 2004, the Senior Revolving Working Capital Facility had a balance outstanding of $7,030. A $5,000 Letter of Credit issuance is available to Heritage Operating for up to 30 days prior to the maturity date of the Working Capital Facility. Letter of Credit Exposure plus the Working Capital Loan cannot exceed the $75,000 maximum Working Capital Facility. Heritage Operating had outstanding Letters of Credit of approximately $1,000 at May 31, 2004.

A $75,000 Senior Revolving Acquisition Facility is available through December 31, 2006. Amounts borrowed under the Acquisition Credit Facility bear interest at a rate based on either a Eurodollar rate or a prime rate. The weighted average interest rate was 2.7250% for the amount outstanding at May 31, 2004. The maximum commitment fee payable on the unused portion of the facility is 0.50%. All receivables, contracts, equipment, inventory, general intangibles, cash concentration accounts, and the capital stock of Heritage Operating s subsidiaries secure the Senior Revolving Acquisition Facility. As of May 31, 2004, the Senior Revolving Acquisition Facility had a balance outstanding of $39,228.

The agreements for each of the Senior Secured Notes, Medium Term Note Program, Senior Secured Promissory Notes, and the Operating Partnerships bank credit facilities contain customary restrictive covenants applicable to the Operating Partnerships, including limitations on substantial disposition of assets, changes in ownership of the Operating Partnerships, the level of additional indebtedness and creation of liens. These covenants require the Operating Partnerships to maintain ratios of Consolidated Funded Indebtedness to Consolidated EBITDA (as these terms are similarly defined in the bank credit facilities and the Note Agreements) of not more than, 4.75 to 1 for Heritage Operating and 4.00 to 1 for La Grange Acquisition and Consolidated EBITDA to Consolidated Interest Expense (as these terms are similarly defined in the bank credit facilities and the Note Agreements) of not less than 2.25 to 1 for Heritage Operating and 2.75 to 1 for La Grange Acquisition. The Consolidated EBITDA used to determine these ratios is calculated in accordance with these debt agreements. For purposes of calculating the ratios under the bank credit facilities and the Note Agreements, Consolidated EBITDA is based upon the Operating Partnerships EBITDA, as adjusted for the most recent four quarterly periods, and modified to give pro forma effect for acquisitions and divestures made during the test period and is compared to Consolidated Funded Indebtedness as of the test date and the Consolidated Interest Expense for the most recent twelve months. These debt agreements also provide that the Operating Partnerships may declare, make, or incur a liability to make, restricted payments during each fiscal quarter, if: (a) the amount of such restricted payment, together with all other restricted payments during such quarter, do not exceed Available Cash with respect to the immediately preceding quarter; (b) no default or event of default exists before such restricted payments; and (c) each Operating Partnership s restricted payment is not greater than the product of each Operating Partnership s Percentage of Aggregate Available Cash multiplied by the Aggregate Partner Obligations (as these terms are similarly defined in the bank credit facilities and the Note Agreements). The debt agreements further provide that Heritage Operating s Available Cash is required to reflect a reserve equal to 50% of the interest to be paid on the notes and in addition, in the third, second and first quarters preceding a quarter in which a scheduled principal payment is to be made on the notes, Available Cash is required to reflect a reserve equal to 25%, 50%, and 75%, respectively, of the principal amount to be repaid on such payment dates.

Failure to comply with the various restrictive and affirmative covenants of the Operating Partnerships bank credit facilities and the Note Agreements could negatively impact the Operating Partnerships ability to incur additional

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debt and/or the Partnership s ability to pay distributions. The Operating Partnerships are required to measure these financial tests and covenants quarterly and were in compliance with all requirements, tests, limitations, and covenants related to the Senior Secured Notes, Medium Term Note Program and Senior Secured Promissory Notes, and the bank credit facilities at May 31, 2004.

6. INCOME TAXES:

The components of the deferred tax liability were as follows:

	May 31, 2004	August 31, 2003
		(Energy Transfer Company)
Property, plant and equipment	$111,412	$ 55,736
Other	486	(351)
	$111,898	$ 55,385

7. COMMITMENTS AND CONTINGENCIES:

Commitments

Certain property and equipment is leased under noncancelable leases, which require fixed monthly rental payments and expire at various dates through 2020. Rental expense under these leases totaled approximately $755 and $1,599 for the three and nine months ended May 31, 2004, respectively, and $256 and $643 for the three and eight months ended May 31, 2003, respectively, and has been included in operating expenses in the accompanying statements of operations. Predecessor Heritage s rental expense under these leases was approximately $471 and $1,941 for the three and nine months ended May 31, 2003. Certain of these leases contain renewal options and also contain escalation clauses, which are accounted for on a straight-line basis over the minimum lease term. Fiscal year future minimum lease commitments for such leases are $978 in 2004; $3,751 in 2005; $1,731 in 2006; $940 in 2007; $532 in 2008 and $842 thereafter.

The Partnership has forward commodity contracts, which will be settled by physical delivery. Short-term contracts, which expire in less than one year, require delivery up to 39 million MMBtu per day. Long-term contracts total require delivery of up to 157 MMBtu per day. The long-term contracts run through July 2013.

The Partnership has entered into several propane purchase and supply commitments with varying terms as to quantities and prices, which expire at various dates through March 2005.

La Grange Acquisition in the normal course of business, purchases, processes and sells natural gas pursuant to long-term contracts. Such contracts contain terms that are customary in the industry. The Partnership believes that such terms are commercially reasonable and will not have a material adverse effect on the Partnership s financial position or results of operations.

Litigation

The Partnership is a party to various legal proceedings and/or regulatory proceedings incidental to its business. Certain claims, suits and complaints arising in the ordinary course of business have been filed or are pending against the Partnership. In the opinion of management, all such matters are either covered by insurance, are without merit or involve amounts, which, if resolved unfavorably, would not have a significant effect on the financial position or results of operations of the Partnership. Once management determines that information pertaining to a legal proceeding indicates that it is probable that a liability has been incurred, an accrual is established equal to management s estimate of the likely exposure. For matters that are covered by insurance, the Partnership accrues the related deductible. As of May 31, 2004 and August 31, 2003, an accrual of $1,320 and $112, respectively, was recorded as accrued and other current liabilities on the Partnership s consolidated balance sheets. As of August 31, 2003, Predecessor Heritage had an accrual of $941 that was recorded as accrued and other current liabilities.

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Environmental

The Partnership s operations are subject to extensive federal, state and local environmental laws and regulations that require expenditures for remediation at operating facilities and waste disposal sites. Although the Partnership believes its operations are in substantial compliance with applicable environmental laws and regulations, risks of additional costs and liabilities are inherent in the natural gas pipeline and processing business, and there can be no assurance that significant costs and liabilities will not be incurred. Moreover, it is possible that other developments, such as increasingly stringent environmental laws, regulations and enforcement policies thereunder, and claims for damages to property or persons resulting from the operations, could result in substantial costs and liabilities. Accordingly, the Partnership has adopted policies, practices, and procedures in the areas of pollution control, product safety, occupational health, and the handling, storage, use, and disposal of hazardous materials to prevent material environmental or other damage, and to limit the financial liability, which could result from such events. However, some risk of environmental or other damage is inherent in the natural gas pipeline and processing business, as it is with other entities engaged in similar businesses.

In conjunction with the October 1, 2002 acquisition of the Texas and Oklahoma natural gas gathering and gas processing assets from Aquila Gas Pipeline, Aquila, Inc. agreed to indemnify La Grange Acquisition for any environmental liabilities that arose from the operation of the assets for the period prior to October 1, 2002. Aquila also agreed to indemnify La Grange Acquisition for 50% of any environmental liabilities that arose from the operations of Oasis Pipe Line Company prior to October 1, 2002.

Petroleum-based contamination or environmental wastes are known to be located on or adjacent to six sites, on which the Partnership presently has, or formerly had, operations. These sites were evaluated at the time of their acquisition. In all cases, remediation operations have been or will be undertaken by others, and in all six cases, Predecessor Heritage obtained indemnification for expenses associated with any remediation from the former owners or related entities. The Partnership has not been named as a potentially responsible party at any of these sites, nor has the Partnership s operations contributed to the environmental issues at these sites. Accordingly, no amounts have been recorded in the Partnership s May 31, 2004 balance sheet. Additionally, no amount was recorded in Predecessor Heritage s August 31, 2003 balance sheet. Based on information currently available to the Partnership, such projects are not expected to have a material adverse effect on the Partnership s financial condition or results of operations.

In July 2001, Predecessor Heritage acquired a company that had previously received a request for information from the U.S. Environmental Protection Agency (the EPA) regarding potential contribution to a widespread groundwater contamination problem in San Bernardino, California, known as the Newmark Groundwater Contamination. Although the EPA has indicated that the groundwater contamination may be attributable to releases of solvents from a former military base located within the subject area that occurred long before the facility acquired by Predecessor Heritage was constructed, it is possible that the EPA may seek to recover all or a portion of groundwater remediation costs from private parties under the Comprehensive Environmental Response, Compensation, and Liability Act (commonly called Superfund). Based upon information currently available to the Partnership, it is believed that the Partnership s liability if such action were to be taken by the EPA would not have a material adverse effect on the Partnership s financial condition or results of operations.

Environmental exposures and liabilities are difficult to assess and estimate due to unknown factors such as the magnitude of possible contamination, the timing and extent of remediation, the determination of the Partnership s liability in proportion to other parties, improvements in cleanup technologies and the extent to which environmental laws and regulations may change in the future. Although environmental costs may have a significant impact on the results of operations for any single period, the Partnership believes that such costs will not have a material adverse effect on its financial position. As of May 31, 2004 and August 31, 2003, an accrual of $504 and $633 was recorded in the Partnership s balance sheet to cover any material environmental liabilities that were not covered by the environmental indemnifications.

8. PRICE RISK MANAGEMENT ASSETS AND LIABILITIES:

Commodity Price Risk

The Partnership is exposed to market risks related to the volatility of natural gas and NGL prices. To reduce the impact of this price volatility, the Partnership primarily uses derivative commodity instruments (futures and swaps) to manage its exposures to fluctuations in margins. The fair value of all derivatives that are designated and documented as cash flow hedges and determined to be effective are recorded through other comprehensive income until the settlement month. When the physical transaction settles, any gain or loss previously recorded in other comprehensive income (loss) on the derivative is recognized in the statement of operations. Unrealized gains or losses on derivatives that do not meet the requirements for hedge accounting are recognized in the statement of operations. The Partnership s derivative instruments were as follows at May 31, 2004:

	Commodity	Notional Volume MMBTU	Maturity	Fair Value
Basis Swaps IFERC/Nymex	Gas	47,730,000	2004-2005	$(1,416)
Basis Swaps IFERC/Nymex	Gas	52,005,000	2004-2005	2,331
				$ 915
Swing Swaps IFERC	Gas	141,720,000	2004-2005	$ 1,717
Swing Swaps IFERC	Gas	86,810,000	2004-2005	(1,237)
				$ 480
Futures Nymex	Gas	3,150,000	2004-2005	$ 1,984
Futures Nymex	Gas	3,027,500	2004-2005	(1,230)
				$ 754

Estimates related to the Partnership s gas marketing activities are sensitive to uncertainty and volatility inherent in the energy commodities markets and actual results could differ from these estimates. Long-term physical contracts are tied to index prices. System gas, which is also tied to index prices, will provide the gas required by the Partnership s long-term physical contracts. When third-party gas is required to supply long-term contracts, a hedge is put in place to protect the margin on the contract.

Interest Rate Risk

The Partnership is exposed to market risk for changes in interest rates related to its bank credit facilities. An interest rate swap agreement is used to manage a portion of the exposure related to LaGrange Acquisition s Term Loan Facility to changing interest rates by converting floating rate debt to fixed-rate debt. On October 9, 2002, La Grange Acquisition, L.P. entered into an interest rate swap agreement to manage its exposure to changes in interest rates. The interest rate swap has a notional value of $75,000 and matures on October 9, 2005. Under the terms of the interest rate swap agreement, the Partnership will pay a fixed rate of 2.76% and will receive three-month LIBOR with quarterly settlement commencing on January 9, 2003. Management has elected to designate the swap as a hedge for accounting purposes. The value of the interest rate swap at May 31, 2004 and August 31, 2003 is a liability of $542 and $807, respectively.

The following represents gain (loss) on derivative activity:

	Three Months Ended May 31, 2004	Three Months Ended May 31, 2003	Nine Months Ended May 31, 2004	Eight Months Ended May 31, 2003
		(Energy Transfer Company)		(Energy Transfer Company)
Realized and unrealized gain (loss) on derivative activities recognized in earnings	$ 3,352	$ 1,367	$ 13,554	$ (5,326)
Realized loss on interest rate swap included in interest expense	$ (297)	$ (874)	$ (1,358)	$ (1,224)

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9. PARTNERS   CAPITAL:

Units

Common Units, Class D Units, Special Units, Class E Units and Class C Units represent limited partner interests in the Partnership that entitle the holders thereof to the rights and privileges specified in the Partnership Agreement, as amended. As of May 31, 2004, there were issued and outstanding 27,919,974 Common Units and 7,721,542 Class D Units representing an aggregate 98% limited partner interest in the Partnership. Except as described below, the Common Units and Class D Units generally participate pro rata in the Partnership   s income, gains, losses, deductions, credits, and distributions. There are also 4,426,916 Class E Units outstanding that are entitled to receive distributions in accordance with their terms, 3,742,515 Special Units outstanding that received no distributions until the Bossier pipeline became commercially operational, and 1,000,000 Class C Units outstanding that are entitled only to participate in distributions that are attributable to the net amount received by the Partnership in connection with the SCANA litigation (defined below).

No person is entitled to preemptive rights in respect of issuances of securities by the Partnership, except that U.S. Propane, has the right to purchase sufficient partnership securities to maintain its general partner equity interest in the Partnership.

Common Units. The Partnership   s Common Units are registered under the Securities Act of 1933 and are listed for trading on the New York Stock Exchange. Each holder of a Common Unit is entitled to one vote per unit on all matters presented to the Limited Partners for a vote except that holders of Common Units acquired by La Grange Energy in connection with the Energy Transfer Transactions will be entitled to vote upon the proposal to change the terms of the Class D Units and Special Units in the same proportion as the votes cast by the holders of the Common Units other than La Grange Energy with respect to the proposals. In addition, if at any time any person or group (other than the Partnership   s General Partner and its affiliates) owns beneficially 20% or more of all Common Units, any Common Units owned by that person or group may not be voted on any matter and are not considered to be outstanding when sending notices of a meeting of Unitholders (unless otherwise required by law), calculating required votes, determining the presence of a quorum or for other similar purposes under the Partnership Agreement. The Common Units are entitled to distributions of Available Cash as described below under   Quarterly Distributions of Available Cash.

Class C Units. The 1,000,00