

STAR GAS FINANCE CO  
Form 10-Q  
August 03, 2010  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, DC 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2010

OR

**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: 001-14129

Commission File Number: 333-103873

**STAR GAS PARTNERS, L.P.**

# STAR GAS FINANCE COMPANY

(Exact name of registrants as specified in its charters)

<b>Delaware</b>	<b>06-1437793</b>
<b>Delaware</b>	<b>75-3094991</b>
(State or other jurisdiction	(I.R.S. Employer
of incorporation or organization)	Identification No.)
<b>2187 Atlantic Street, Stamford, Connecticut</b>	<b>06902</b>
(Address of principal executive office)	
<b>(203) 328-7310</b>	
(Registrants telephone number, including area code)	
(Former name, former address and former fiscal year, if changed since last report)	

Indicate by check mark whether the registrants (1) have 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) have been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).\* Yes  No

\* The registrant has not yet been phased into the interactive data requirements.

Indicate by check mark whether the registrants are large accelerated filers, accelerated filers, non-accelerated filers or smaller reporting companies. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input checked="" type="checkbox"/>
Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input type="checkbox"/>

Indicate by check mark whether the registrants are shell companies (as defined in Rule 12b-2 of the Act). Yes  No

At July 31, 2010, the registrants had units and shares of each issuer's classes of common stock outstanding as follows:

Star Gas Partners, L.P.	Common Units	68,274,306
Star Gas Partners, L.P.	General Partner Units	325,729



**Table of Contents**

**STAR GAS PARTNERS, L.P. AND SUBSIDIARIES**

**INDEX TO FORM 10-Q**

	<b>Page</b>
<b>Part I Financial Information</b>	
Item 1 Condensed Consolidated Financial Statements	
<u>Condensed Consolidated Balance Sheets as of June 30, 2010 (unaudited) and September 30, 2009</u>	3
<u>Condensed Consolidated Statements of Operations for the three and nine months ended June 30, 2010 and June 30, 2009 (unaudited)</u>	4
<u>Condensed Consolidated Statement of Partners' Capital and Comprehensive Income for the nine months ended June 30, 2010 (unaudited)</u>	5
<u>Condensed Consolidated Statements of Cash Flows (unaudited) for the nine months ended June 30, 2010 and June 30, 2009</u>	6
<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	7-20
Item 2 <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	21-40
Item 3 <u>Quantitative and Qualitative Disclosures About Market Risk</u>	40
Item 4 <u>Controls and Procedures</u>	41
<b>Part II Other Information:</b>	
<u>Item 1 Legal Proceedings</u>	41
<u>Item 1A Risk Factors</u>	41
<u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u>	42
<u>Item 6 Exhibits</u>	42
<u>Signatures</u>	43

**Table of Contents**

**STAR GAS PARTNERS, L.P. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands)	June 30, 2010 (unaudited)	September 30, 2009
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 43,951	\$ 195,160
Receivables, net of allowance of \$8,446 and \$6,267, respectively	106,074	58,854
Inventories	62,851	62,636
Fair asset value of derivative instruments	6,652	14,676
Current deferred tax asset, net	24,940	30,135
Prepaid expenses and other current assets	20,545	15,437
<b>Total current assets</b>	<b>265,013</b>	<b>376,898</b>
Property and equipment, net	43,971	37,494
Long-term portion of accounts receivables	662	504
Goodwill	202,803	182,942
Intangibles, net	59,552	20,468
Long-term deferred tax asset, net	1,300	36,265
Deferred charges and other assets, net	6,721	9,555
<b>Total assets</b>	<b>\$ 580,022</b>	<b>\$ 664,126</b>
<b>LIABILITIES AND PARTNERS' CAPITAL</b>		
<b>Current liabilities</b>		
Accounts payable	\$ 15,788	\$ 17,103
Fair liability value of derivative instruments	276	665
Accrued expenses and other current liabilities	70,061	64,446
Unearned service contract revenue	40,066	37,121
Customer credit balances	33,533	74,153
<b>Total current liabilities</b>	<b>159,724</b>	<b>193,488</b>
Long-term debt	82,797	133,112
Other long-term liabilities	30,821	31,192
<b>Partners' capital</b>		
Common unitholders	331,516	332,340
General partner	397	309
Accumulated other comprehensive income (loss), net of taxes	(25,233)	(26,315)
<b>Total partners' capital</b>	<b>306,680</b>	<b>306,334</b>
<b>Total liabilities and partners' capital</b>	<b>\$ 580,022</b>	<b>\$ 664,126</b>

See accompanying notes to condensed consolidated financial statements.



**Table of Contents****STAR GAS PARTNERS, L.P. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per unit data - unaudited)	Three Months Ended June 30,		Nine Months Ended June 30,	
	2010	2009	2010	2009
<b>Sales:</b>				
Product	\$ 130,168	\$ 126,404	\$ 942,646	\$ 959,433
Installations and service	46,593	41,265	134,666	131,586
Total sales	176,761	167,669	1,077,312	1,091,019
<b>Cost and expenses:</b>				
Cost of product	93,345	85,100	669,573	658,511
Cost of installations and service	40,066	37,447	128,255	130,790
(Increase) decrease in the fair value of derivative instruments	2,324	(9,656)	(5,770)	(15,064)
Delivery and branch expenses	45,076	44,776	169,770	180,903
Depreciation and amortization expenses	4,083	3,744	11,179	15,853
General and administrative expenses	5,748	5,302	16,447	15,556
Operating income (loss)	(13,881)	956	87,858	104,470
Interest expense	(3,103)	(4,119)	(11,258)	(13,487)
Interest income	1,421	1,305	2,750	3,593
Amortization of debt issuance costs	(660)	(564)	(1,988)	(1,732)
Gains (loss) on redemption of debt			(1,132)	9,740
Income (loss) before income taxes	(16,223)	(2,422)	76,230	102,584
Income tax expense (benefit)	(6,232)	(498)	33,681	3,852
Net income (loss)	\$ (9,991)	\$ (1,924)	\$ 42,549	\$ 98,732
General Partner's interest in net income (loss)	(47)	(8)	194	423
Limited Partners' interest in net income (loss)	\$ (9,944)	\$ (1,916)	\$ 42,355	\$ 98,309
Basic and Diluted income (loss) per Limited Partner Unit (1)	\$ (0.14)	\$ (0.03)	\$ 0.53	\$ 1.07
<b>Weighted average number of Limited Partner units outstanding:</b>				
Basic and Diluted	69,469	75,774	70,819	75,774

(1) See Note 2 Summary of Significant Accounting Policies - Net Income (Loss) per Limited Partner Unit.  
See accompanying notes to condensed consolidated financial statements.

Table of Contents

**STAR GAS PARTNERS, L.P. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENT OF PARTNERS' CAPITAL**  
**AND COMPREHENSIVE INCOME**

(in thousands)	Number of Units		Common	General Partner	Accum. Other Comprehensive Income (Loss)	Total Partners Capital
	Common	General Partner				
Balance as of September 30, 2009	75,137	326	\$ 332,340	\$ 309	\$ (26,315)	\$ 306,334
Comprehensive income (unaudited):						
Net income			42,355	194		42,549
Unrealized gain on pension plan obligation					1,848	1,848
Tax affect of unrealized gain on pension plan					(766)	(766)
Total comprehensive income			42,355	194	1,082	43,631
Distributions			(15,251)	(106)		(15,357)
Retirement of units (1)	(6,863)		(27,928)			(27,928)
Balance as of June 30, 2010 (unaudited)	68,274	326	\$ 331,516	\$ 397	\$ (25,233)	\$ 306,680

(1) See Note 2 - Common Unit Repurchase and Retirement.

See accompanying notes to condensed consolidated financial statements.



**Table of Contents****STAR GAS PARTNERS, L.P. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands - unaudited)	Nine Months Ended June 30,	
	2010	2009
<b>Cash flows provided by (used in) operating activities:</b>		
Net income	\$ 42,549	\$ 98,732
Adjustment to reconcile net income to net cash provided by (used in) operating activities:		
(Increase) decrease in fair value of derivative instruments	(5,770)	(15,064)
Depreciation and amortization	13,167	17,585
(Gains) loss on redemption of debt	1,132	(9,740)
Provision for losses on accounts receivable	6,570	9,257
Change in deferred taxes	30,368	
Changes in operating assets and liabilities:		
(Increase) decrease in receivables	(41,717)	4,350
(Increase) decrease in inventories	1,871	(10,595)
Decrease in other assets	13,624	9,191
Decrease in accounts payable	(2,622)	(752)
Decrease in customer credit balances	(44,425)	(24,806)
Increase (decrease) in other current and long-term liabilities	(500)	2,650
Net cash provided by operating activities	14,247	80,808
<b>Cash flows provided by (used in) investing activities:</b>		
Capital expenditures	(3,581)	(2,495)
Proceeds from sales of fixed assets	220	153
Acquisitions (net of cash acquired of \$3,390 and \$0, respectively)	(67,703)	(3,313)
Earnout	(123)	
Net cash used in investing activities	(71,187)	(5,655)
<b>Cash flows provided by (used in) financing activities:</b>		
Revolving credit facility borrowings	36,754	
Revolving credit facility repayments	(36,754)	
Repayment of debt	(50,854)	(26,271)
Distributions	(15,357)	(10,274)
Unit repurchase	(27,928)	
Deferred charges	(130)	
Net cash used in financing activities	(94,269)	(36,545)
Net increase (decrease) in cash and cash equivalents	(151,209)	38,608
Cash and cash equivalents at beginning of period	195,160	178,808
Cash and cash equivalents at end of period	\$ 43,951	\$ 217,416

See accompanying notes to condensed consolidated financial statements.



**Table of Contents**

**STAR GAS PARTNERS, L.P. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**1) Partnership Organization**

Star Gas Partners, L.P. ( Star Gas Partners, the Partnership, we, us, or our ) is a home heating oil distributor and services provider with one reportable operating segment that principally provides services to residential and commercial customers to heat their homes and buildings. Star Gas Partners is a master limited partnership, which at June 30, 2010, had outstanding 68.3 million common units (NYSE: SGU ) representing 99.5% limited partner interest in Star Gas Partners, and 0.3 million general partner units, representing 0.5% general partner interest in Star Gas Partners.

The Partnership is organized as follows:

The general partner of the Partnership is Kestrel Heat, LLC, a Delaware limited liability company ( Kestrel Heat or the general partner ). The Board of Directors of Kestrel Heat is appointed by its sole member, Kestrel Energy Partners, LLC, a Delaware limited liability company ( Kestrel ).

The Partnership's operations are conducted through Petro Holdings, Inc. and its subsidiaries ( Petro ). Petro is a Minnesota corporation that is an indirect wholly-owned subsidiary of the Partnership. Petro is a Northeast and Mid-Atlantic region retail distributor of home heating oil that at June 30, 2010 served approximately 410,000 full-service residential and commercial home heating oil customers, and 10,000 propane customers. Petro also sold home heating oil, gasoline and diesel fuel to approximately 35,000 customers on a delivery only basis. In addition, Petro installed, maintained, and repaired heating and air conditioning equipment for its customers, and provided ancillary home services, including home security and plumbing, to approximately 12,000 customers.

Star Gas Finance Company is a 100% owned subsidiary of the Partnership. Star Gas Finance Company serves as the co-issuer, jointly and severally with the Partnership, of the Partnership's \$82.5 million 10.25% Senior Notes (excluding discounts and premiums), which are due in 2013. The Partnership is dependent on distributions including inter-company interest payments from its subsidiaries to service the Partnership's debt obligations. The distributions from the Partnership's subsidiaries are not guaranteed and are subject to certain loan restrictions. Star Gas Finance Company has nominal assets and conducts no business operations. (See Note 6. Long-Term Debt and Bank Facility Borrowings)

**2) Common Unit Repurchase and Retirement**

On July 21, 2009, the Board of Directors of the Partnership's General Partner authorized the repurchase of up to 7.5 million of the Partnership's common units ( Plan I ). As of June 30, 2010, all 7.5 million common units authorized for repurchase under the Plan I program were repurchased and retired. The Partnership's repurchase activities took into account SEC safe harbor rules and guidance for issuer repurchases.

On July 19, 2010, the Board of Directors of the Partnership's General Partner authorized the repurchase of up to 7.0 million of the Partnership's common units ( Plan II ). The authorized common unit repurchases may be made from time-to-time in the open market, in privately negotiated transactions or in such other manner deemed appropriate by management. In order to facilitate the repurchase program, the Partnership intends to enter into a prearranged unit repurchase plan under Rule 10b5-1 of the Securities Act of 1933, as amended for up to 4.0 million common units with a third party broker. There is no guarantee of the exact number of units that will be purchased under the program and the Partnership may discontinue purchases at any time. The program does not have a time limit. The Partnership's repurchase activities take into account SEC safe harbor rules and guidance for issuer repurchases. All of the common units purchased in the repurchase program will be retired.

**Table of Contents**

(in thousands, except per unit amounts)

Period	Total Number of Units Purchased as Part of a Publicly Announced Plan or Program	Average Price Paid per Unit (a)	Maximum Number of Units that May Yet Be Purchased Under the Plan I Program
Number of units authorized			7,500
Fiscal year 2009 total	637	\$ 3.67	6,863
October 2009	3,072	\$ 3.97	3,791
November 2009	350	\$ 3.96	3,441
December 2009	834	\$ 3.95	2,607
First quarter fiscal year 2010 total	4,256	\$ 3.97	2,607
January 2010		\$	2,607
February 2010	964	\$ 4.03	1,643
March 2010		\$	1,643
Second quarter fiscal year 2010 total	964	\$ 4.03	1,643
April 2010	110	\$ 4.30	1,533
May 2010	254	\$ 4.36	1,279
June 2010	1,279	\$ 4.36	
Third quarter fiscal year 2010 total	1,643	\$ 4.36	
Total number of units repurchased under the Plan I program	7,500	\$ 4.04	

(a) Amounts include repurchase costs.

**3) Summary of Significant Accounting Policies*****Basis of Presentation***

The Consolidated Financial Statements include the accounts of Star Gas Partners, L.P. and its subsidiaries. All material inter-company items and transactions have been eliminated in consolidation.

The financial information included herein is unaudited; however, such information reflects all adjustments (consisting solely of normal recurring adjustments), which are, in the opinion of management, necessary for the fair statement of financial condition and results for the interim periods. Due to the seasonal nature of the Partnership's business, the results of operations for the three and nine-month periods ended June 30, 2010 and June 30, 2009 are not necessarily indicative of the results to be expected for the full year.

## Edgar Filing: STAR GAS FINANCE CO - Form 10-Q

These interim financial statements of the Partnership have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and Rule 10-01 of Regulation S-X of the U.S. Securities and Exchange Commission and should be read in conjunction with the Partnership's Annual Report on Form 10-K for the year ended September 30, 2009.

### ***Reclassification***

Certain prior year amounts have been reclassified to conform with the current year presentation.

### ***Use of Estimates***

The preparation of financial statements in accordance 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 disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

## **Table of Contents**

### ***Revenue Recognition***

Sales of heating oil and other fuels are recognized at the time of delivery of the product to the customer and sales of heating and air conditioning equipment are recognized at the time of installation. Revenue from repairs and maintenance service is recognized upon completion of the service. Payments received from customers for heating oil equipment service contracts are deferred and amortized into income over the terms of the respective service contracts, on a straight-line basis, which generally do not exceed one year. To the extent that the Partnership anticipates that future costs for fulfilling its contractual obligations under its service maintenance contracts will exceed the amount of deferred revenue currently attributable to these contracts, the Partnership recognizes a loss in current period earnings equal to the amount that anticipated future costs exceed related deferred revenues.

### ***Cost of Product***

Cost of product includes the cost of heating oil, diesel, kerosene, heavy oil, gasoline, throughput costs, barging costs, option costs, and realized gains/losses on closed derivative positions for product sales.

### ***Cost of Installations and Service***

Cost of installations and service includes equipment and material costs, wages and benefits for equipment technicians, dispatchers and other support personnel, subcontractor expenses, commissions and vehicle related costs.

### ***Delivery and Branch Expenses***

Delivery and branch expenses include insurance, wages and benefits and department related costs for drivers, dispatchers, mechanics, customer service, sales and marketing, compliance, credit and branch accounting, information technology and operational support.

### ***General and Administrative Expenses***

General and administrative expenses include wages and benefits and department related costs for human resources, finance and accounting, and administrative support.

### ***Allowance for Doubtful Accounts***

The Partnership periodically reviews current and past due customer accounts receivable balances. After giving consideration to economic conditions, overdue status and other factors, it establishes an allowance for doubtful accounts, representing the Partnership's best estimate of amounts that may not be collectible.

### ***Allocation of Net Income (Loss)***

Net income (loss) for partners' capital and statement of operations is allocated to the general partner and the limited partners in accordance with their respective ownership percentages, after giving effect to cash distributions paid to the general partner in excess of its ownership interest, if any.

### ***Net Income (Loss) per Limited Partner Unit***

Income per limited partner unit is computed in accordance with FASB ASC 260-10-45-60 Basic and Diluted Earnings per Share topic, Participating Securities and the Two-Class Method subtopic (EITF 03-06), by dividing the limited partners' interest in net income by the weighted average number of limited partner units outstanding. The pro forma nature of the allocation required by this standard provides that in any accounting period where the Partnership's aggregate net income exceeds its aggregate distribution for such period, the Partnership is required to present net income per limited partner unit as if all of the earnings for the periods were distributed, regardless of whether those earnings would actually be distributed during a particular period from an economic or practical perspective. This allocation does not impact the Partnership's overall net income or other financial results. However, for periods in which the Partnership's aggregate net income exceeds its aggregate distributions for such period, it will have the impact of reducing the earnings per limited partner unit, as the calculation according to this standard results in a theoretical increased allocation of undistributed earnings to the general partner. In accounting periods where aggregate net income does not exceed aggregate distributions for such period, this standard does not have any impact on the Partnership's net income per limited partner unit calculation. A separate and independent calculation for each quarter and year-to-date period is required.



**Table of Contents**

The following presents the net income allocation and per unit data using this method for the periods presented:

<b>Basic and Diluted Earnings Per Limited Partner: (in thousands, except per unit data)</b>	<b>Three Months Ended June 30,</b>		<b>Nine Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Net income (loss)	\$ (9,991)	\$ (1,924)	\$ 42,549	\$ 98,732
Less General Partners' interest in net income (loss)	(47)	(8)	194	423
Net income (loss) available to limited partners	(9,944)	(1,916)	42,355	98,309
Less dilutive impact of theoretical distribution of earnings under FASB ASC 260-10-45-60			5,000	16,934
Limited Partner's interest in net income (loss) under FASB ASC 260-10-45-60	\$ (9,944)	\$ (1,916)	\$ 37,355	\$ 81,375
<b>Per unit data:</b>				
Basic and diluted net income (loss) available to limited partners	\$ (0.14)	\$ (0.03)	\$ 0.60	\$ 1.30
Less dilutive impact of theoretical distribution of earnings under FASB ASC 260-10-45-60			0.07	0.23
Limited Partner's interest in net income (loss) under FASB ASC 260-10-45-60	\$ (0.14)	\$ (0.03)	\$ 0.53	\$ 1.07
Weighted average number of Limited Partner units outstanding	69,469	75,774	70,819	75,774

**Cash Equivalents**

The Partnership considers all highly liquid investments with a maturity of three months or less, when purchased, to be cash equivalents.

**Inventories**

The Partnership's inventory of heating oil and other fuels are stated at the lower of cost computed on the weighted average cost (WAC) method, or market. All other inventories, representing parts and equipment are stated at the lower of cost computed on the FIFO method, or market.

<b>(in thousands)</b>	<b>June 30, 2010</b>	<b>September 30, 2009</b>
Heating oil and other fuels	\$ 47,515	\$ 48,504
Fuel oil parts and equipment	15,336	14,132
	\$ 62,851	\$ 62,636

**Derivatives and Hedging Disclosures and Fair Value Measurements**

The Partnership uses derivative instruments such as futures, options, and swap agreements, in order to mitigate exposure to market risk associated with the purchase of home heating oil for price-protected customers, physical inventory on hand, inventory in transit and priced purchase commitments.

To hedge a substantial majority of the purchase price associated with heating oil gallons anticipated to be sold to its price-protected customers as of June 30, 2010, the Partnership bought 0.9 million gallons of physical inventory and had 0.7 million gallons of swap contracts to buy heating oil; 37.2 million gallons of call options; 0.7 million gallons of put options and 18.3 million net gallons of synthetic calls (a swap combined with



## Edgar Filing: STAR GAS FINANCE CO - Form 10-Q

two or one offsetting puts, at different prices). To hedge the inter-month differentials for our price-protected customers, its physical inventory on hand, and inventory in transit, the Partnership as of June 30, 2010 had 14.2 million gallons of future contracts to buy heating oil; 20.8 million gallons of future contracts to sell heating oil; and 15.7 million gallons of swap contracts to sell heating oil. To hedge a portion of its internal fuel usage, the Partnership as of June 30, 2010, had 0.9 million gallons of swap contracts to buy gasoline and 1.0 million gallons of swap contracts to buy diesel.

To hedge a substantial majority of the purchase price associated with heating oil gallons anticipated to be sold to its price-protected customers as of June 30, 2009, the Partnership had 4.2 million gallons of swap contracts to buy heating oil;

---

**Table of Contents**

0.3 million gallons of futures contracts to sell heating oil, along with 58.4 million gallons of call options and 2.9 million gallons of put options. The Partnership also had synthetic calls of 3.9 million net gallons. In addition, to hedge the inter-month differentials for our price-protected customers, its physical inventory on hand, and inventory in transit, the Partnership as of June 30, 2009 had 40.2 million gallons of futures contract to buy heating oil; 44.9 million gallons of future contracts to sell heating oil; and 21.5 million gallons of swap contracts to sell heating oil. To hedge a portion of its internal fuel usage, the Partnership as of June 30, 2009, had 0.4 million gallons of future contracts and 1.5 million gallons of swap contracts to buy gasoline and 1.4 million gallons of swap contracts to buy diesel.

The Partnership's derivative instruments are with the following counterparties: Newedge USA, LLC, JPMorgan Chase Bank, NA, Societe Generale, Key Bank National Association, Cargill, Inc., Wachovia Bank, NA, and Bank of America, N.A. The Partnership assesses counterparty credit risk and maintains master netting arrangements with its counterparties to help manage this risks and records its derivative positions on a net basis. Based on its assessment, the Partnership considers counterparty credit risk to be low. At June 30, 2010, the aggregate cash posted as collateral in the normal course of business at counterparties was \$0.1 million.

FASB ASC 815-10-05 Derivatives and Hedging topic (SFAS 133), established accounting and reporting standards requiring that derivative instruments be recorded at fair value and included in the consolidated balance sheet as assets or liabilities, along with qualitative disclosures regarding the derivative activity. To the extent derivative instruments designated as cash flow hedges are effective and the standard's documentation requirements have been met, changes in fair value are recognized in other comprehensive income until the underlying hedged item is recognized in earnings. The Partnership has elected not to designate its derivative instruments as hedging instruments under this standard and the change in fair value of the derivative instruments is recognized in our statement of operations in the line item (increase) decrease in the fair value of derivative instruments. Realized gains and losses are recorded in cost of product.

FASB ASC 820-10 Fair Value Measurements and Disclosures topic (SFAS 157), established a three-tier fair value hierarchy, which classified the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices for identical instruments in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions. The Partnership's Level 1 derivative assets and liabilities represent the fair value of commodity contracts used in its hedging activities that are identical and traded in active markets. The Partnership's Level 2 derivative assets and liabilities represent the fair value of commodity contracts used in its hedging activities that are valued using either directly or indirectly observable inputs, whose nature, risk and class are similar. No significant transfers of assets or liabilities have been made into and out of the Level 1 or Level 2 tiers. All derivative instruments were non-trading positions. The market prices used to value the Partnership's derivatives have been determined using the New York Mercantile Exchange ( NYMEX ) and independent third party prices that are reviewed for reasonableness.

The Partnership had no assets or liabilities that are measured at fair value on a nonrecurring basis subsequent to their initial recognition. The Partnership's financial assets and liabilities measured at fair value on a recurring basis are listed on the following table.

**Table of Contents**

(In thousands)

Derivatives Not Designated as Hedging Instruments	Under FASB ASC 815-10	Balance Sheet Location	Total	Fair Value Measurements at Reporting Date Using:		
				Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
<b>Asset Derivatives at June 30, 2010</b>						
Commodity contracts		Fair asset and fair liability value of derivative instruments	\$ 13,373	\$ 3,493	\$ 9,880	\$
Commodity contracts		Long-term derivative assets included in the deferred charges and other assets, net balance	125	125		
<b>Commodity contract assets at June 30, 2010</b>			<b>\$ 13,498</b>	<b>\$ 3,618</b>	<b>\$ 9,880</b>	<b>\$</b>
<b>Liability Derivatives at June 30, 2010</b>						
Commodity contracts		Fair liability and fair asset value of derivative instruments	\$ 6,997	\$ 2,960	\$ 4,037	\$
<b>Commodity contract liabilities at June 30, 2010</b>			<b>\$ 6,997</b>	<b>\$ 2,960</b>	<b>\$ 4,037</b>	<b>\$</b>
<b>Asset Derivatives at September 30, 2009</b>						
Commodity contracts		Fair asset and fair liability value of derivative instruments	\$ 23,867	\$ 3,875	\$ 19,992	\$
Commodity contracts		Long-term derivative assets included in the deferred charges and other assets, net balance	389	133	256	
<b>Commodity contract assets at September 30, 2009</b>			<b>\$ 24,256</b>	<b>\$ 4,008</b>	<b>\$ 20,248</b>	<b>\$</b>
<b>Liability Derivatives at September 30, 2009</b>						
Commodity contracts		Fair liability and fair asset value of derivative instruments	\$ (9,856)	\$ (3,986)	\$ (5,870)	\$
<b>Commodity contract liabilities at September 30, 2009</b>			<b>\$ (9,856)</b>	<b>\$ (3,986)</b>	<b>\$ (5,870)</b>	<b>\$</b>

(In thousands)

Derivatives Not Designated as Hedging Instruments	Location of (Gain) or Loss Recognized in Income on Derivative	The Effect of Derivative Instruments on the Statement of Operations			
		Amount of (Gain) or Loss Recognized			
		Three Months Ended June	Three Months Ended June 30,	Nine Months Ended June 30,	Nine Months Ended June 30,

Edgar Filing: STAR GAS FINANCE CO - Form 10-Q

Under FASB ASC 815-10		30, 2010	2009	2010	2009
Commodity contracts	Cost of product (a)	\$ 1,001	\$ 13,100	\$ 22,005	\$ 76,049
Commodity contracts	(Increase) / decrease in the fair value of derivative instruments	\$ 2,324	\$ (9,656)	\$ (5,770)	\$ (15,064)

(a) Represents realized closed positions and includes the cost of options as they expire.

**Table of Contents****Weather Hedge Contract**

Weather hedge contract is recorded in accordance with the intrinsic value method defined by FASB ASC 815-45-15 Derivatives and Hedging topic, Weather Derivatives subtopic (EITF 99-2). The premium paid is amortized over the life of the contract and the intrinsic value method is applied at each interim period.

**Property and Equipment**

Property and equipment are stated at cost. Depreciation is computed over the estimated useful lives of the depreciable assets using the straight-line method.

(in thousands)	June 30, 2010	September 30, 2009
Property and equipment	\$ 144,935	\$ 135,269
Less: accumulated depreciation	100,964	97,775
Property and equipment, net	\$ 43,971	\$ 37,494

**Business Combinations**

The Partnership uses the acquisition method of accounting in accordance to FASB ASC 805 Accounting for Business Combinations and Noncontrolling Interests (SFAS 141(R)). The acquisition method of accounting requires the Partnership to use significant estimates and assumptions, including fair value estimates, as of the business combination date, and to refine those estimates as necessary during the measurement period (defined as the period, not to exceed one year, in which the amounts recognized for a business combination may be adjusted). Each acquired company's operating results are included in the Partnership's consolidated financial statements starting on the date of acquisition. The purchase price is equivalent to the fair value of consideration transferred. Tangible and identifiable intangible assets acquired and liabilities assumed as of the date of acquisition, are recorded at the acquisition date fair value. The separately identifiable intangible assets generally are comprised of customer lists, trade names and covenants not to compete. Goodwill is recognized for the excess of the purchase price over the net fair value of assets acquired and liabilities assumed.

Costs that are incurred to complete the business combination such as investment banking, legal and other professional fees are not considered part of consideration transferred, and are charged to general and administrative expense as they are incurred. For any given acquisition, certain contingent consideration may be identified. Estimates of the fair value of liability or asset classified contingent consideration are included under the acquisition method as part of the assets acquired or liabilities assumed. At each reporting date, these estimates are remeasured to fair value, with changes recognized in earnings.

**Goodwill and Intangible Assets**

Goodwill and intangible assets include goodwill, customer lists and covenants not to compete.

Goodwill is the excess of cost over the fair value of net assets in the acquisition of a company. Under FASB ASC 350-10-05 Intangibles-Goodwill and Other topic (SFAS No. 142), a potential goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value. If goodwill of a reporting unit is determined to be impaired, the amount of impairment is measured based on the excess of the net book value of the goodwill over the implied fair value of the goodwill.

The Partnership has selected August 31 of each year to perform its annual impairment review under this standard. The evaluations utilize an Income Approach and Market Approach (consisting of the Market Comparable and the Market Transaction Approach), which contain reasonable and supportable assumptions and projections reflecting management's best estimate in deriving the Partnership's total enterprise value. The Income Approach calculates over a discrete period the free cash flow generated by the Partnership to determine the enterprise value. The Market Comparable approach compares the Partnership to comparable companies in similar industries to determine the enterprise value. The Market Transaction approach uses exchange prices in actual sales and purchases of comparable businesses to determine the enterprise value.

## Edgar Filing: STAR GAS FINANCE CO - Form 10-Q

The total enterprise value as indicated by these two approaches is compared to the Partnership's book value of net assets and reviewed in light of the Partnership's market capitalization.

Customer lists are the names and addresses of an acquired company's customers. Based on historical retention experience, these lists are amortized on a straight-line basis over seven to ten years.

**Table of Contents**

Trade names are the names of acquired companies. Based on the economic benefit expected and historical retention experience of customers, trade names are amortized on a straight-line basis over seven to ten years.

Covenants not to compete are agreements with the owners of acquired companies and are amortized over the respective lives of the covenants on a straight-line basis, which are generally five years.

**Partners' Capital**

Comprehensive income includes net income (loss), plus certain other items that are recorded directly to partners' capital. Accumulated other comprehensive income reported on the Partnerships' consolidated balance sheets consists of unrealized gains/losses on pension plan obligations and the tax affect. For the three months ended June 30, 2010, comprehensive loss was \$(9.6) million, comprised of net loss of \$(10.0) million, an unrealized gain on pension plan obligation of \$0.6 million and the tax affect of \$(0.2) million. For the three months ended June 30, 2009, comprehensive loss was \$(1.6) million, comprised of net loss of \$(2.0) million and an unrealized gain on pension plan obligation of \$0.4 million.

For the nine months ended June 30, 2010, comprehensive income was \$43.6 million, comprised of net income of \$42.5 million, an unrealized gain on pension plan obligation of \$1.8 million and the tax affect of \$(0.7) million. For the nine months ended June 30, 2009, comprehensive income was \$99.8 million, comprised of net income of \$98.7 million and an unrealized gain on pension plan obligation of \$1.0 million.

**Income Taxes**

The Partnership is a master limited partnership and is not subject to tax at the entity level for Federal and state income tax purposes. Rather, income and losses of the Partnership are allocated directly to the individual partners. While the Partnership will generate non-qualifying Master Limited Partnership revenue, distributions from the corporate subsidiaries to the Partnership are generally included in the determination of qualified Master Limited Partnership income. All or a portion of the distributions received by the Partnership from the corporate subsidiaries could be taxable as a dividend or capital gain to the partners.

The accompanying financial statements are reported on a fiscal year, however, the Partnership and its Corporate subsidiaries file Federal and state income tax returns on a calendar year.

As most of the Partnership's income is derived from its corporate subsidiaries, these financial statements reflect significant Federal and state income taxes. For corporate subsidiaries of the Partnership, a consolidated Federal income tax return is filed. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amount of assets and liabilities and their respective tax bases and operating loss carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is recognized if, based on the weight of available evidence including historical tax losses, it is more likely than not that some or all of deferred tax assets will not be realized.

Until September 30, 2009, the Partnership's deferred tax assets and liabilities related to its corporate subsidiaries were fully offset by a valuation allowance. Approximately \$86.4 million of this valuation allowance was released as of September 30, 2009, resulting in net deferred tax assets being recorded on the balance sheet. As a result of this change, any comparison of the income tax expense (benefit) in the first three fiscal quarters of 2009 to the corresponding quarters of fiscal 2010 will be comparing current income tax expense (benefit) in the fiscal 2009 quarters to both current and deferred income tax expense (benefit) in fiscal 2010 quarters. The comparative current and deferred income tax expense for the three and nine months ended June 30, 2010, and 2009 is as follows:

(in thousands)	Three Months Ended June 30,		Nine Months Ended June 30,	
	2010	2009	2010	2009
Income (loss) before taxes	\$ (16,223)	\$ (2,422)	\$ 76,230	\$ 102,584
Current tax expense (benefit)	\$ (810)	\$ (498)	\$ 3,316	\$ 3,852
Deferred tax expense (benefit)	(5,422)		30,365	
Total tax expense (benefit)	\$ (6,232)	\$ (498)	\$ 33,681	\$ 3,852





**Table of Contents**

As of the calendar tax year ended December 31, 2009, Star Acquisitions, a wholly-owned subsidiary of the Partnership, had a Federal net operating loss carry forward ( NOL ) of approximately \$52 million. The NOLs, which will expire between 2018 and 2024, are generally available to offset any future taxable income. In the event that the Partnership experiences an ownership change for Federal income tax purposes under Internal Revenue Code Section 382 ( Section 382 ), Star Acquisitions may be restricted annually in its ability to use its NOLs to reduce its Federal taxable income. In general, the Partnership would be deemed to have an ownership change under Section 382 if, immediately after any owner shift involving a 5% unitholder or any equity structure shift, the percentage of units of the Partnership owned by one or more 5% unitholder has increased by more than 50% over the lowest percentage of units of the Partnership (or any predecessor entity) owned by such unitholder at any time during the three-year testing period.

FASB ASC 740-10-05-6 Income Taxes topic, Tax Position subtopic (SFAS No. 109 and FIN 48), provides financial statement accounting guidance for uncertainty in income taxes and tax positions taken or expected to be taken in a tax return.

At June 30, 2010, we had unrecognized income tax benefits totaling \$2.1 million including related accrued interest and penalties of \$0.2 million. These unrecognized tax benefits are primarily the result of Federal tax uncertainties. If recognized, these tax benefits and related interest and penalties would reduce the effective tax rate.

We believe that the total liability for unrecognized tax benefits will decrease by \$0.1 million during the next 12 months ending June 30, 2011. Our continuing practice is to recognize interest and penalties related to income tax matters as a component of income tax expense.

We file U.S. Federal income tax returns and various state and local returns. A number of years may elapse before an uncertain tax position is audited and finally resolved. For our Federal income tax returns we have four tax years subject to examination. In our major state tax jurisdictions of New York, Pennsylvania, Connecticut, and New Jersey, we have four, four, five, and five tax years, respectively, that are subject to examination. While it is often difficult to predict the final outcome or the timing of resolution of any particular uncertain tax position, based on our assessment of many factors including past experience and interpretation of tax law, we believe that our provision for income taxes reflect the most probable outcome. This assessment relies on estimates and assumptions and may involve a series of complex judgments about future events.

***Sales, Use and Value Added Taxes***

Taxes are assessed by various governmental authorities on many different types of transactions. Sales reported for product, installation and service exclude taxes.

***Recent Accounting Pronouncements***

In the first quarter of fiscal 2010, the Partnership adopted the provisions of FASB ASC 805-10 Business Combinations (SFAS No. 141R). This standard establishes in a business combination principles and requirements for how an acquirer recognizes and measures identifiable assets acquired, goodwill acquired, liabilities assumed, and any noncontrolling interests.

**4) Goodwill and Intangibles, net****Goodwill**

A summary of changes in the Partnership's goodwill is as follows (in thousands):

Balance as of September 30, 2009	\$ 182,942
Fiscal year 2010 activity and earnout	19,861
<b>Balance as of June 30, 2010</b>	<b>\$ 202,803</b>

The Partnership performed its annual goodwill impairment valuation for the period ending August 31, 2009 and determined that there was no goodwill impairment. The preparation of this analysis (see Note 3. Summary of Significant Accounting Policies – Goodwill and Intangible Assets) was based upon management's estimates and assumptions, and future impairment calculations would be affected by actual results that are materially different from projected amounts. To provide for a sensitivity of the discount rates and transaction multiples used, ranges of high and

## Edgar Filing: STAR GAS FINANCE CO - Form 10-Q

low values are employed in the analysis, with the low values examined to ensure that a reasonably likely change in an assumption would not cause the Partnership to reach a different conclusion.

**Table of Contents****Intangibles, net**

The gross carrying amount and accumulated amortization of intangible assets subject to amortization are as follows:

(in thousands)	June 30, 2010			September 30, 2009		
	Gross Carrying Amount	Accum. Amortization	Net	Gross Carrying Amount	Accum. Amortization	Net
Customer lists and other intangibles	\$ 250,206	\$ 190,654	\$ 59,552	\$ 204,426	\$ 183,958	\$ 20,468

Amortization expense for intangible assets was \$6.7 million for the nine months ended June 30, 2010 compared to \$10.9 million for the nine months ended June 30, 2009. Amortization expense was lower as acquisitions from 1999 with a 10 year life became fully amortized in fiscal 2009. Total estimated annual amortization expense related to intangible assets subject to amortization, for the fiscal year ending September 30, 2010 and the four succeeding fiscal years ending September 30, is as follows (in thousands):

	Estimated Annual Book Amortization Expense
2010	\$ 9,469
2011	\$ 10,007
2012	\$ 5,640
2013	\$ 5,638
2014	\$ 5,562

**5) Business Combinations**

The Partnership acquired four heating oil dealers for the nine months ended June 30, 2010.

The following table summarizes the preliminary fair values and purchase price allocation at the acquisition dates, of the assets acquired and liabilities assumed related to acquisitions made as of June 30, 2010. These values are preliminary pending final valuation of intangibles, certain deferred tax assets and certain working capital items.

(in thousands)	As of Acquisition Date
Trade accounts receivable (a)	\$ 12,231
Inventories	2,086
Other current assets	5,226
Furniture and equipment	4,522
Fleet	2,679
Customer lists and other intangibles	38,380
Trade names	7,400
Current liabilities	(15,531)
Long-term deferred tax liabilities	(9,029)
Total net identifiable assets acquired	\$ 47,964
Total consideration transferred	\$ 67,825
Less: Total net identifiable assets acquired	47,964
Goodwill	\$ 19,861

## Edgar Filing: STAR GAS FINANCE CO - Form 10-Q

- (a) The gross contractual receivable amount is \$14.8 million, and the best estimate at the acquisition date of the contractual cash flows not expected to be collected is \$2.6 million.

The total costs related to these acquisitions were included in the Consolidated Statement of Operations under general and administrative expenses and were \$0.6 million.

**Table of Contents**

Of the \$19.9 million of goodwill relating to these acquisitions, \$2.8 million is deductible for income tax purposes. Goodwill is being derived from the ability of the businesses to regenerate customers and to a lesser extent, certain synergies.

Except for the acquisition of the Champion Energy Corporation ( Champion ), the other acquisitions noted above, individually and in the aggregate were not material to the Partnership.

Included in the figures above is the acquisition of Champion. On May 10, 2010, the Partnership entered into an Equity Purchase Agreement pursuant to which it acquired 100% of the capital stock of Champion for a purchase price of approximately \$50.1 million plus working capital of approximately \$7.5 million (net of cash acquired), payable in cash. The business reason for this acquisition is that Champion is an excellent fit for the Partnership, as it serves over 45,000 home heating oil customers in markets in which the Partnership currently operates, and sold 35.2 million gallons of residential home heating oil, 4.1 million gallons of commercial home heating oil and 8.9 million gallons of other petroleum products for the twelve months ending June 30, 2009.

A remediation liability of \$4.1 million has been recognized as of the acquisition date in connection with Champion. The remediation liability was determined by management and primarily represents the costs to remediate a Champion facility. An estimated range of the remediation costs is expected to be between \$1.8 million and \$5.9 million, with \$4.1 million representing the fair value of the expected total cost as of the acquisition date.

Sales and net loss of Champion for fiscal 2010 totaled \$10.0 million and \$(0.7) million, respectively for the period from the acquisition date through June 30, 2010.

The following table provides unaudited pro forma results of operations as if the Champion acquisition had occurred on October 1, 2008. The unaudited pro forma results were prepared using Champion's current and prior year financial information, reflecting certain adjustments related to the acquisition, such as the elimination of select nonrecurring charges, and changes to administrative, interest and depreciation and amortization expenses. These pro forma adjustments do not include any potential synergies related to combining the businesses. Accordingly, such pro forma operating results were prepared for comparative purposes only and do not purport to be indicative of what would have occurred had the acquisition been made as of October 1, 2008 or of results that may occur in the future.

(in thousands)	Three Months Ended		Nine Months Ended	
	June 30, (Unaudited)		June 30, (Unaudited)	
	2010	2009	2010	2009
Net sales	\$ 186,295	\$ 188,086	\$ 1,193,322	\$ 1,216,163
Net earnings	\$ (10,337)	\$ (2,633)	\$ 48,038	\$ 108,438

**Table of Contents****6) Long-Term Debt and Bank Facility Borrowings**

The Partnership's debt is as follows (in thousands):

	At June 30, 2010		At September 30, 2009	
	Carrying Amount	Estimated Fair Value (a)	Carrying Amount	Estimated Fair Value (a)
10.25% Senior Notes (b)	\$ 82,797	\$ 82,797	\$ 133,112	\$ 133,112
Revolving Credit Facility Borrowings (c)				
<b>Total debt</b>	<b>\$ 82,797</b>	<b>\$ 82,797</b>	<b>\$ 133,112</b>	<b>\$ 133,112</b>
Total long-term portion of debt	\$ 82,797	\$ 82,797	\$ 133,112	\$ 133,112

- (a) The Partnership's fair value estimates of long-term debt are made at a specific point in time, based on relevant market information, open market quotations and information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.
- (b) These notes mature in February 2013 and accrue interest at an annual rate of 10.25% requiring semi-annual interest payments on February 15 and August 15 of each year. The net premium on these notes included above were \$0.3 million at June 30, 2010 and \$0.6 million at September 30, 2009, respectively. These notes are redeemable at the option of the Partnership, in whole or in part, from time to time by payment of a premium. In February 2010, \$50 million in principal amount of these notes were redeemed at a price equal to 101.708% of face value plus any accrued and unpaid interest.

Under the terms of the indenture these notes permit restricted payments of \$22 million, allow the Partnership to incur acquisition related debt of up to \$60 million without passing certain financial tests, and restrict the proceeds of asset sales from being invested in current assets for purposes of the asset sale covenant.

- (c) In July 2009, the Partnership entered into an amended and restated asset based revolving credit facility agreement with a bank syndication comprised of nine banks. This amended facility, that extends to July 2012, provides the Partnership with the ability to borrow up to \$240 million (\$290 million during the heating season from November to April each year) for working capital purposes (subject to certain borrowing base limitations and coverage ratios), including the issuance of up to \$100 million in letters of credit which reduce availability under this facility. The Partnership can increase the facility size by \$50 million without the consent of the bank group. The bank group is not obligated to fund the \$50 million increase. If the bank group elects not to fund the increase, the Partnership can add additional lenders to the group, with the consent of the Agent, which shall not be unreasonably withheld. The interest rate is LIBOR plus (i) 3.50% (if availability, as defined in the revolving credit facility agreement is greater than or equal to \$150 million), or (ii) 3.75% (if availability is greater than \$75 million but less than \$150 million), or (iii) 4.00% (if availability is less than or equal to \$75 million). The commitment fee on the unused portion of the facility is 0.75% per annum.

In January 2010, the Partnership entered into a first amendment to the amended and restated asset based revolving credit facility agreement that updated the consolidated fixed charges defined term.

At June 30, 2010, no amount was outstanding under the revolving credit facility and \$42.3 million of letters of credit were issued. No amount was outstanding under the revolving credit facility at September 30, 2009, and \$40.9 million of letters of credit were issued.

Obligations under the revolving credit facility are secured by liens on substantially all assets and are guaranteed by the Partnership. The revolving credit facility imposes certain restrictions on the Partnership, including restrictions on its ability to incur additional indebtedness, to pay distributions to its unitholders, to pay inter-company dividends or distributions, make investments, grant liens, sell assets, make acquisitions and engage in certain other activities. The revolving credit facility also requires the Partnership to maintain certain financial ratios, and contains borrowing conditions and customary events of default, including nonpayment of principal or interest, violation of covenants, inaccuracy of representations and warranties, cross-defaults to other indebtedness, bankruptcy and other insolvency events. The occurrence of an event of default or an acceleration under the revolving credit facility would result in the Partnership's inability to obtain further borrowings under that

facility, which could adversely affect its results of

**Table of Contents**

operations. Such a default may also restrict the ability of the Partnership to obtain funds from its subsidiaries in order to pay interest or paydown debt. An acceleration under the revolving credit facility would result in a default under the Partnership's other funded debt.

Under the terms of the revolving credit facility, the Partnership must maintain at all times either availability (borrowing base less amounts borrowed and letters of credit issued) of \$43.5 million or a fixed charge coverage ratio (as defined in the credit agreement) of not less than 1.10x. In addition, the Partnership must maintain a fixed charge coverage ratio for the trailing twelve months of 1.15x in order to make its minimum quarterly distributions of \$0.0675 per unit, and 1.25x to make any distributions in excess of the minimum quarterly distributions. No inter-company dividends or distributions can be made (including those needed to pay interest or principle on the 10.25% Senior Notes) if the relevant covenant described above has not been met.

As of June 30, 2010, availability was \$112.8 million, and the Partnership was in compliance with the fixed charge coverage ratio. As of September 30, 2009, availability was \$194.4 million, and the Partnership was in compliance with the fixed charge coverage ratio.

**7) Employee Pension Plan**

(in thousands)	Three Months Ended		Nine Months Ended	
	June 30,		June 30,	
	2010	2009	2010	2009
<u>Components of net periodic benefit cost:</u>				
Service cost	\$	\$	\$	\$
Interest cost	812	935	2,435	2,805
Expected return on plan assets	(666)	(728)	(1,998)	(2,184)
Net amortization	616	340	1,848	1,020
Net periodic benefit cost	\$ 762	\$ 547	\$ 2,285	\$ 1,641

As of June 30, 2010, the Partnership contributed \$1.3 million and expects to make an additional \$11.9 million contribution to fund its pension obligation for fiscal 2010.

**8) Supplemental Disclosure of Cash Flow Information**

(in thousands)	Nine Months Ended	
	June 30,	
	2010	2009
<u>Cash paid during the period for:</u>		
Income taxes, net	\$ 1,478	\$ 1,665
Interest	\$ 9,690	\$ 10,420
Debt redemption premium	\$ 854	\$
<u>Non-cash financing activities:</u>		
Decrease in interest expense amortization of net debt premium	\$ 104	\$ 132
Decrease in net debt premium attributable to redemption of debt	\$ 203	\$ 199

**9) Commitments and Contingencies**

The Partnership's operations are subject to all operating hazards and risks normally incidental to handling, storing and transporting and otherwise providing for use by consumers of combustible liquids such as home heating oil and propane. As a result, at any given time the Partnership is a defendant in various legal proceedings and litigation arising in the ordinary course of business. The Partnership maintains insurance policies with insurers in amounts and with coverages and deductibles we believe are reasonable and prudent. However, the Partnership cannot assure that this insurance will be adequate to protect it from all material expenses related to potential future claims for personal and property damage or that these levels of insurance will be available in the future at economical prices. In the opinion of management the Partnership is not a party to any litigation, which individually or in the aggregate could reasonably be expected to have a material adverse effect on the Partnership's results of operations, financial position or liquidity.





**Table of Contents**

**10) Subsequent Events**

**Quarterly Distribution Declared**

On July 19, 2010, the Partnership declared a quarterly distribution of \$0.0725 per common unit, payable on August 13, 2010, to holders of record on August 5, 2010.

**Common Units Repurchase Program - Plan II**

On July 19, 2010, the Board of Directors of the Partnership's General Partner authorized the repurchase of up to 7.0 million of the Partnership's common units ( Plan II ). The authorized common unit repurchases may be made from time-to-time in the open market, in privately negotiated transactions or in such other manner deemed appropriate by management. In order to facilitate the repurchase program, the Partnership intends to enter into a prearranged unit repurchase plan under Rule 10b5-1 of the Securities Act of 1933, as amended for up to 4.0 million common units with a third party broker. There is no guarantee of the exact number of units that will be purchased under the program and the Partnership may discontinue purchases at any time. The program does not have a time limit. The Partnership's repurchase activities take into account SEC safe harbor rules and guidance for issuer repurchases. All of the common units purchased in the repurchase program will be retired.

---

**Table of Contents**

**Item 2.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Statement Regarding Forward-Looking Disclosure**

This Quarterly Report on Form 10-Q includes forward-looking statements which represent our expectations or beliefs concerning future events that involve risks and uncertainties, including those associated with the effect of weather conditions on our financial performance, the price and supply of home heating oil, the consumption patterns of our customers, our ability to obtain satisfactory gross profit margins, our ability to obtain new accounts and retain existing accounts, our ability to make strategic acquisitions, the impact of litigation, our ability to contract for our current and future supply needs, natural gas conversions, future union relations and the outcome of current and future union negotiations, the impact of future environmental, health, and safety regulations, the ability to attract and retain employees, customer credit worthiness, counter party credit worthiness, marketing plans and general economic conditions. All statements other than statements of historical facts included in this Report including, without limitation, the statements under Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere herein, are forward-looking statements. Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct and actual results may differ materially from those projected as a result of certain risks and uncertainties. Important factors that could cause actual results to differ materially from our expectations ( Cautionary Statements ) include, but are not limited to, those set forth under the heading Risk Factors and Business Initiatives and Strategy in the Partnership's Annual Report on Form 10-K (the Form 10-K ) for the fiscal year ended September 30, 2009 and under the heading Risk Factors in this Quarterly Report on Form 10-Q. Without limiting the foregoing, the words believe, anticipate, plan, expect, seek, es and similar expressions are intended to identify forward-looking statements. All subsequent written and oral forward-looking statements attributable to the Partnership or persons acting on its behalf are expressly qualified in their entirety by the Cautionary Statements. Unless otherwise required by law, we undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise after the date of this Report.

**Overview**

The following is a discussion of the historical condition and results of operations of the Partnership and its subsidiaries, and should be read in conjunction with the description of our business in Item 1. Business of the Form 10-K and the historical Financial and Operating Data and Notes thereto included elsewhere in this Report.

**Seasonality**

The following matters should be considered in analyzing our financial results. Our fiscal year ends on September 30. All references to quarters and years respectively in this document are to fiscal quarters and years unless otherwise noted. The seasonal nature of our business results in the sale of approximately 30% of our volume of home heating oil in the first fiscal quarter and 45% of our volume in the second fiscal quarter of each fiscal year, the peak heating season. In addition, sales volume typically fluctuates from year to year in response to variations in weather, wholesale energy prices and other factors.

**Degree Day**

A degree day is an industry measurement of temperature designed to evaluate energy demand and consumption. Degree days are based on how far the average temperature departs from 65°F. Each degree of temperature above 65°F is counted as one cooling degree day, and each degree of temperature below 65°F is counted as one heating degree day. Degree days are accumulated each day over the course of a year and can be compared to a monthly or a long-term (multi-year) average, or normal, to see if a month or a year was warmer or cooler than usual. Degree days are officially observed by the National Weather Service and officially archived by the National Climatic Data Center. For purposes of evaluating our results of operations, we use the normal heating degree day amount as reported by the National Weather Service in our operating areas.

---

**Table of Contents**

**EBITDA and Adjusted EBITDA (Non-GAAP Financial Measures)**

EBITDA (Earnings from continuing operations before net interest expense, income taxes, depreciation and amortization) and Adjusted EBITDA are non-GAAP financial measures that are used as supplemental financial measures by management and external users of our financial statements, such as investors, commercial banks and research analysts, to assess:

our compliance with certain financial covenants included in our debt agreements;

our financial performance without regard to financing methods, capital structure, income taxes or historical cost basis;

our ability to generate cash sufficient to pay interest on our indebtedness and to make distributions to our partners;

our operating performance and return on invested capital as compared to those of other companies in the retail distribution of refined petroleum products business, without regard to financing methods and capital structure; and

the viability of acquisitions and capital expenditure projects and the overall rates of return of alternative investment opportunities.

Adjusted EBITDA is calculated as earnings from continuing operations before net interest expense, income taxes, depreciation and amortization, the (increase) decrease in the fair value of derivatives, gain or loss on debt redemption, goodwill impairment, and other non-cash and non-operating charges. Management believes the presentation of this measure is relevant and useful because it allows investors to view the Partnership's performance in a manner similar to the method management uses, and makes it easier to compare its results with other companies that have different financing and capital structures. In addition, this measure is consistent with the manner in which the Partnership's debt covenants in its material debt agreements are calculated. Both the Partnership's 10.25% Senior Note agreement and its bank credit facility contain covenants that restrict equity distributions, acquisitions, and the amount of debt it can incur. Under the most restrictive of these covenants, which is found in the bank credit facility, the agent bank could step in and control all cash transactions for the Partnership if we failed to comply with the minimum Availability or the fixed charge coverage ratio. The Partnership is required to maintain either availability (borrowing base less amounts borrowed and letters of credit issued) of \$43.5 million (15% of the maximum facility size) or a fixed charge coverage ratio of 1.10x (Adjusted EBITDA being a significant component of this calculation). This method of calculating Adjusted EBITDA may not be consistent with that of other companies and should be viewed in conjunction with measurements that are computed in accordance with GAAP.

Each of EBITDA and Adjusted EBITDA has its limitations as an analytical tool, and it should not be considered in isolation or as a substitute for analysis of our results as reported under GAAP. Some of the limitations of EBITDA and Adjusted EBITDA are:

EBITDA and Adjusted EBITDA do not reflect our cash used for capital expenditures;

Although depreciation and amortization are non-cash charges, the assets being depreciated or amortized often will have to be replaced, and EBITDA and Adjusted EBITDA do not reflect the cash requirements for such replacements;

EBITDA and Adjusted EBITDA do not reflect changes in, or cash requirements for, our working capital requirements;

EBITDA and Adjusted EBITDA do not reflect the cash necessary to make payments of interest or principal on our indebtedness; and

## Edgar Filing: STAR GAS FINANCE CO - Form 10-Q

EBITDA and Adjusted EBITDA do not reflect the cash required to pay taxes.

### **Per Gallon Gross Profit Margins**

We believe the change in home heating oil margins should be evaluated on a cents per gallon basis, before the effects of increases or decreases in the fair value of derivative instruments, as we believe that realized per gallon margins should not include the impact of non-cash changes in the market value of hedges before the settlement of the underlying transaction.

A significant portion of our home heating oil volume is sold to individual customers under an arrangement pre-establishing the ceiling sales price or a fixed price of home heating oil over a fixed period. When these price-protected customers agree to purchase home heating oil from us for the next heating season, we will purchase option contracts, swaps and futures contracts for a substantial majority of the heating oil that we expect to sell to these customers. The amount of home heating oil volume that we hedge per price-protected customer is based upon the estimated fuel consumption per average customer, per month. In the event that the actual usage exceeds the amount of the hedged volume on a monthly basis, we could be required to obtain additional volume at unfavorable margins. In addition, should actual usage in any month be less than the hedged volume, our hedging losses could be greater.

---

## **Table of Contents**

### **Derivatives**

FASB ASC 815-10-05 Derivatives and Hedging topic (FAS 133), established accounting and reporting standards requiring that derivative instruments be recorded at fair value and included in the consolidated balance sheet as assets or liabilities. To the extent derivative instruments designated as cash flow hedges are effective, as defined under this standard, changes in fair value are recognized in other comprehensive income until the forecasted hedged item is recognized in earnings. The Partnership has elected not to designate its derivative instruments as hedging instruments under this standard, and, as a result, the changes in fair value of the derivative instruments are recognized in our statement of operations. Therefore, we experience great volatility in earnings as outstanding home heating oil derivative instruments are marked to market and non-cash gains and losses are recorded prior to the sale of the commodity to the customer. To the extent that the Partnership continues this accounting treatment, the volatility in any given period related to unrealized non-cash gains or losses on derivative home heating oil instruments can be significant to the overall results of the Partnership. However, we ultimately expect those gains and losses to be offset by the cost of product when purchased.

### **Impact of Financial Reform Legislation on Derivatives**

The U.S. Congress has recently passed comprehensive financial reform legislation that requires regulated banks with derivatives trading units to spin them off and that requires substantially all derivatives be traded through a central clearing house, subject to margin requirements. This legislation could substantially increase the Partnership's cost in using certain derivatives and could make such derivatives less available, which could subject the Partnership to additional risks to the extent it is not able to hedge the risks in another manner. The full impact of this legislation on the Partnership cannot be fully determinable until the required rules implementing this legislation have been drafted and adopted by various governmental agencies.

### **Income Taxes Valuation Allowance and Net Operating Loss Carry Forward**

Based upon a review of a number of factors, including historical operating performance and our expectation that we could generate sustainable consolidated taxable income for the foreseeable future, we concluded at the end of fiscal 2009 that the majority of the Partnership's net deferred tax assets should be recognized. Thus, pursuant to FASB ASC 740-10 Income Taxes topic (FAS 109), we recorded a tax benefit during fiscal 2009 reversing a majority of the opening valuation allowance, resulting in a non-cash increase in net income of \$86.4 million. This benefit was partially offset by a current income tax expense of \$3.8 million and deferred income tax expense of \$25.0 million related to current year activity (including net operating loss carry forward utilization), resulting in a net income tax benefit of \$57.6 million.

Most of the \$86.4 million benefit relating to the valuation allowance release related to Federal and state loss carry forwards (NOLs), insurance reserves, and the net operating book versus tax timing of intangible amortization.

The release of the valuation allowance in 2009 will also affect the comparison of income tax expense (benefit) of fiscal 2009 quarters in fiscal 2010. The income tax expense in the first three quarters of fiscal 2009 consisted of current taxes only, as any deferred income tax expense or benefit for those periods were fully offset by movements in the valuation allowance.

At December 31, 2004, we had Federal NOLs of \$170.6 million and at December 31, 2009, these NOLs were reduced to approximately \$52 million. Over this five year period, we utilized approximately \$24 million of Federal NOLs on average each year to offset our taxable income. We expect that over the next few years, we will utilize the majority of the remaining NOLs. After we exhaust the NOLs, the amount of cash taxes that we will pay will increase significantly and will reduce the annual amount of cash available for distribution to unitholders. For example, in calendar 2006, 2007, 2008 and 2009 we paid Federal cash taxes of \$0.1 million, \$1.0 million, \$0.6 million and \$0.6 million, respectively. If we did not have the NOLs available to us for calendar 2006, 2007, 2008 and 2009 our Federal cash taxes would have increased to \$2.6 million, \$17.2 million, \$11.1 million and \$10.1 million for calendar 2006, 2007, 2008 and 2009, respectively.

### **Income Taxes- Book Versus Tax Deductions**

The amount of cash flow that we generate in any given year depends upon a variety of factors including the amount of cash income taxes that our corporate subsidiary will pay. The amount of depreciation and amortization that we deduct for book (i.e. financial reporting) purposes will differ from the amount that our corporate subsidiary can deduct for tax purposes. The table below compares the estimated depreciation and amortization for book purposes to the amount that our corporate subsidiary expects to deduct for tax purposes. (Our corporate subsidiary files its tax return based on a calendar year. The amounts below are based on our fiscal year.)



**Table of Contents****Estimated Depreciation and Amortization Expense**

(Amounts in 000 \$)

<b>Fiscal Year</b>	<b>Book</b>	<b>Tax</b>
2010	\$ 17,954	\$ 30,944
2011	18,324	29,842
2012	12,202	26,829
2013	9,162	23,799
2014	8,119	20,050

**Income Taxes Consideration of Election to be Taxed as an Association or C Corporation**

Currently, the Partnership's main asset and source of income is an investment in Star Acquisitions, Inc. Our unitholders do not receive any of the tax benefits normally associated with owning units in a publicly traded partnership, as any cash coming from Star Acquisitions to the Partnership will generally have been taxed first at a corporate level and then may also be taxable to our unitholders as dividends, reported via annual Forms K-1. The production of the Forms K-1 themselves is an expensive and administratively intensive process. Thus, the Partnership has all the administrative issues and costs associated with being a large, publicly traded partnership, but our unitholders do not currently receive any material tax benefits from this structure.

To reduce these administrative expenses and to better rationalize our tax reporting structure, the Partnership is evaluating whether to make an election sometime in calendar 2010 or thereafter, to be treated as a corporation for Federal and state income tax purposes. While the Partnership would still remain a publicly traded partnership for legal and governance purposes, for income tax purposes its unitholders would be treated as owning stock in a corporation rather than being partners in a partnership. Subsequent to the year of election unitholders would receive Forms 1099-DIV annually for any dividends and would no longer receive K-1's. In the year of election unitholders would receive both, each form covering part of the year.

This election may have immediate short term tax implications as unitholders who own units during the calendar year of the election could receive taxable dividend income related to the deemed exchange of partnership units for stock and the assumption by the new corporation of the liabilities of the Partnership (primarily the Senior Notes).

Assuming that the Partnership's taxable earnings and profits are equal to or less than the amount of distributions/dividends paid out during the year by the Partnership and that the unitholder holds the units for the entire calendar year, (or at least long enough during the year to receive a distribution(s) at least equal to the tax resulting from a share of dividend income reported on Form K-1), then most unitholders should not have any material negative cash flow consequences as a result of the Partnership making this election. Note that nothing herein should be interpreted as a projection of any future earnings amount or a projection or guarantee of future distributions or dividends.

In addition, there are risks that the Partnership could make this election but:

Not distribute or dividend enough cash to cover the taxes that may be due as a result of the dividend income generated by the election.

Even if total distributions are made by the Partnership that are equal to its total taxable earnings in the year of election, any particular unit holder could buy or sell units in a time period such that they would receive an allocation on their K-1 of more taxable dividend income than they would receive in cash distributions.

The Partnership intends to make this election only if it believes that it will have no overall material adverse impact on its unitholders, of which there can be no assurance. Since determining this is a function of projecting taxable earnings, making assumptions regarding the payment of distributions, and trying to determine when, during any particular calendar year, making the election will have the least impact on the most number of unitholders, when or, even if, it will make this election is not determinable at this time. Unitholders are encouraged to consult their tax advisors with respect to these possible outcomes.





**Table of Contents****Acquisitions**

From April 1 to June 30, 2010, the Partnership completed four acquisitions after the heating season and added approximately 55,600 home heating oil, propane and security accounts. While these acquisitions will provide additional revenues in fiscal 2010, the Partnership's profitability measures such as operating income and net income for fiscal 2010 will be adversely impacted as we expect that product costs and operating expenses from these acquisitions during the balance of fiscal 2010 will exceed revenues, which is normal for this period.

**Customer Attrition**

We measure net customer attrition for our full service residential and commercial home heating oil customers. Net customer attrition is the difference between gross customer losses and customers added through internal marketing efforts. Customers purchased in acquisitions are not included in the calculation of gross customer gains, but are factored on a pro-rata basis in the denominator when calculating the percentages of gross customer gains and losses. Gains and losses at acquisitions since the acquired date of the acquisition are included in the calculation of net customer attrition. Gross customer losses are the result of a number of factors, including price competition, move-outs, credit losses and conversions to natural gas. When a customer moves out of an existing home we count the move out as a loss and if we are successful in signing up the new homeowner, the move in is treated as a gain.

**Gross customer gains and gross customer losses**

	Fiscal Year					
	2010			2009		
	Gross Customer Gains	Losses	Net Attrition	Gross Customer Gains	Losses	Net Attrition
First Quarter	19,000	21,600	(2,600)	26,300	31,800	(5,500)
Second Quarter	11,000	14,200	(3,200)	11,700	24,100	(12,400)
Third Quarter	5,300	12,600	(7,300)	5,900	12,300	(6,400)
	35,300	48,400	(13,100)	43,900	68,200	(24,300)

**Net customer attrition as a percentage of the home heating oil customer base.**

	Fiscal Year					
	2010			2009		
	Gross Customer Gains	Losses	Net Attrition	Gross Customer Gains	Losses	Net Attrition
First Quarter	5.1%	5.8%	-0.7%	6.5%	7.9%	-1.4%
Second Quarter	3.0%	3.8%	-0.8%	2.9%	6.0%	-3.1%
Third Quarter	1.3%	3.1%	-1.8%	1.5%	3.1%	-1.6%
	9.4%	12.7%	-3.3%	10.9%	17.0%	-6.1%

We lost 13,100 accounts (net) during the nine months ended June 30, 2010, or 3.3% of our home heating oil customer base, as compared to the nine months ended June 30, 2009 in which we lost 24,300 accounts (net), or 6.1% of our home heating oil customers, as the decline in gross customer gains of 8,600 accounts was less than the reduction in gross customer losses of 19,800 accounts. As a result of the extreme price volatility in the summer and fall of 2008, the Partnership was able to take advantage of an unusually high number of consumers seeking an alternate supplier in the nine months ended June 30, 2009, which resulted in an increase in gross customer gains for the nine months ended June 30, 2009. These conditions did not reoccur in the nine months ended June 30, 2010 and gross customer gains were lower. The decrease in gross customer losses of 19,800 accounts was primarily due to the aforementioned market condition, as losses due to price declined by 10,100 accounts. In addition, our credit losses improved by 7,100 account and natural gas conversions declined by 1,700.

## Edgar Filing: STAR GAS FINANCE CO - Form 10-Q

We believe that the continued adverse economic conditions and price volatility will adversely impact our ability to attract customers and retain existing customers in the future.

**Table of Contents**

**Protected Price Account Renewals**

Approximately 77% of the Partnership's protected price customers have agreements with us that are subject to annual renewal in the period from April through November of each fiscal year. If a significant number of these customers elect not to renew their protected price agreements with us and do not continue as our customers under a variable price-plan, the Partnership's near term profitability, liquidity and cash flow will be adversely impacted. Based on the recent prices, these price-protected customers will be offered renewal contracts at higher prices than last year which may adversely impact the acceptance rate of these renewals.

**Results of Operations**

The following is a discussion of the results of operations of the Partnership and its subsidiaries, and should be read in conjunction with the historical Financial and Operating Data and Notes thereto included elsewhere in this Quarterly Report.

**Table of Contents****Three Months Ended June 30, 2010****Compared to the Three Months Ended June 30, 2009****Volume**

For the three months ended June 30, 2010, retail volume of home heating oil decreased by 8.1 million gallons, or 18.9%, to 34.9 million gallons, as compared to 43.0 million gallons for the three months ended June 30, 2009. An analysis of the change in the retail volume of home heating oil, which is based on management's estimates, sampling and other mathematical calculations, is found below:

(in millions of gallons)	Heating Oil
Volume - Three months ended June 30, 2009	43.0
Impact of warmer temperatures	(9.0)
Net customer attrition residential / commercial	(1.5)
Acquisitions	1.4
Other	1.0
Change	(8.1)
Volume - Three months ended June 30, 2010	34.9

Temperatures in our geographic areas of operations for the three months ended June 30, 2010 were 27.5% warmer than the three months ended June 30, 2009 and approximately 33.0% warmer than normal, as reported by the National Oceanic Atmospheric Administration (NOAA). Between July 1, 2009 and June 30, 2010, net customer attrition was 4.8%, and the above table reflects the lost volume related to this net customer attrition.

Volume of other petroleum products for the three months ended June 30, 2010 increased by 0.7 million gallons, or 9.1%, to 8.3 million gallons, as compared to 7.6 million gallons of other petroleum products sold during the three months ended June 30, 2009. While acquisitions added 1.4 million gallons of other petroleum products, we experienced a decline in the base business of 0.7 million gallons due to competitive pressures, selective reductions in our customer base due to increases in both our credit and profitability standards, as well as the downturn in the economy.

The percentage of heating oil volume sold to residential variable price customers increased to 41.9% for the three months ended June 30, 2010, as compared to 40% for the three months ended June 30, 2009. The percentage of heating oil volume sold to residential price-protected customers decreased to 43.8% for the three months ended June 30, 2010, as compared to 45.6% for the three months ended June 30, 2009. For the three months ended June 30, 2010, sales to commercial/industrial customers decreased to 14.3% of total heating oil volume sales, as compared to 14.5% for the three months ended June 30, 2009.

**Product Sales**

For the three months ended June 30, 2010, product sales increased \$3.8 million, or 3.0%, to \$130.2 million, as compared to \$126.4 million for the three months ended June 30, 2009, due largely to an increase in other petroleum product sales of \$6.1 million due to an increase in selling prices and an increase in volume. Home heating oil product sales declined by \$2.3 million as the impact of higher home heating oil selling prices of 20.7% was more than offset by a decline in home heating oil volume of 18.9%, reflecting the aforementioned warmer weather. The Partnership increased home heating oil and other petroleum products selling prices in response to an increase in the wholesale cost of product.

**Installation and Service Sales**

For the three months ended June 30, 2010, service and installation sales increased \$5.3 million, or 12.9%, to \$46.6 million, as compared to \$41.3 million for the three months ended June 30, 2009 due to additional service and installation revenue from stand alone acquisitions of \$2.1 million and additional air conditioning installation and service revenue of \$2.5 million resulting from the 27.5% warmer temperatures.



**Table of Contents****Cost of Product**

For the three months ended June 30, 2010, cost of product increased \$8.2 million, or 9.7%, to \$93.3 million, as compared to \$85.1 million for the three months ended June 30, 2009, as an increase in the wholesale cost for all products and the additional volume sold of other petroleum products was partially reduced by the previously mentioned 18.9% decline in home heating oil volume.

**Gross Profit Product**

The table below calculates the Partnership's per gallon margins and reconciles product gross profit for home heating oil and other petroleum products. We believe the change in home heating oil margins should be evaluated before the effects of increases or decreases in the fair value of derivative instruments, as we believe that realized per gallon margins should not include the impact of non-cash changes in the market value of hedges before the settlement of the underlying transaction. On that basis, home heating oil margins for the three months ended June 30, 2010 increased by \$0.0792 per gallon, or 8.8%, to \$0.9769 per gallon, from \$0.8977 per gallon in the three months ended June 30, 2009. Product sales and cost of product include home heating oil, other petroleum products and liquidated damages billings.

	Three Months Ended			
	June 30, 2010		June 30, 2009	
	Amount (000)	Per Gallon	Amount (000)	Per Gallon
<b>Home Heating Oil</b>				
Volume (in gallons)	34,866		42,976	
Sales	\$ 109,223	\$ 3.1326	\$ 111,532	\$ 2.5952
Cost	75,161	2.1557	72,950	1.6975
Gross Profit	\$ 34,062	\$ 0.9769	\$ 38,582	\$ 0.8977
	Amount (000)	Per Gallon	Amount (000)	Per Gallon
<b>Other Petroleum Products</b>				
Volume (in gallons)	8,333		7,640	
Sales	\$ 20,945	\$ 2.5134	\$ 14,872	\$ 1.9465
Cost	18,184	2.1822	12,151	1.5904
Gross Profit	\$ 2,761	\$ 0.3312	\$ 2,721	\$ 0.3560
	Amount (000)		Amount (000)	Change
<b>Total Product</b>				
Sales	\$ 130,168		\$ 126,404	\$ 3,765
Cost	\$ 93,345		85,101	(8,245)
Gross Profit	\$ 36,823		\$ 41,303	\$ (4,480)

For the three months ended June 30, 2010, total product gross profit decreased by \$4.5 million to \$36.8 million, as compared to \$41.3 million for the three months ended June 30, 2009, as the impact of higher home heating oil per gallon margins (\$2.8 million) was more than offset by lower home heating oil volume (\$7.3 million).

---

**Table of Contents****(Increase) Decrease in the Fair Value of Derivative Instruments**

During the three months ended June 30, 2010, the decrease in the fair value of derivative instruments resulted in the recording of a \$2.3 million debit due to the expiration of certain hedged positions or their realization to cost of product (\$1.2 million credit) and a decrease in the market value for unexpired hedges (\$3.5 million charge).

During the three months ended June 30, 2009, the decrease in the fair value of derivative instruments resulted in the recording of a \$9.7 million credit due to the expiration of certain hedged positions or their realization to cost of product (\$7.9 million credit), and an increase in the market value for unexpired hedges (\$1.8 million credit).

**Cost of Installations and Service**

During the three months ended June 30, 2010, the cost of installations and service increased \$2.7 million, or 7.2%, to \$40.1 million, as compared to \$37.4 million for the three months ended June 30, 2009, as the additional costs from stand alone acquisitions of \$1.6 million and the increase in installation costs due to the rise in installation sales was reduced by lower vehicle fuel costs of \$0.8 million. Management views the service and installation department on a combined basis because many expenses cannot be separated or allocated to either service or installation billings. Many administrative functions and direct expenses such as service technician time cannot be precisely allocated.

Installation costs were \$13.5 million, or 85.6% of installation sales during the three months ended June 30, 2010, versus \$11.9 million, or 89.7% of installation sales during the three months ended June 30, 2009. The decline in installation costs as a percentage of sales was largely the result of reduced staffing levels, as the Partnership responded to the impact on sales of the economic downturn. In the three months ended June 30, 2009 the Partnership did not reduce staffing levels as quickly as the decline in installation revenues. Service expenses increased to \$26.6 million, or 86.2% of service sales during the three months ended June 30, 2010, from \$25.5 million in the three months ended June 30, 2009, or 91.2% of sales. This increase in service costs of \$1.1 million was largely due to recent acquisitions. The decline in service costs as a percentage of service revenue was due to higher profitability of the increased air conditioning service, the decline in vehicle fuels, and the fact that our recent acquisitions have a lower cost as a percentage of service revenue. For the three months ended June 30, 2010, a net gross profit from service and installation of \$6.5 million was generated, as compared to a gross profit of \$3.8 million for the three months ended June 30, 2009.

**Delivery and Branch Expenses**

For the three months ended June 30, 2010, delivery and branch expenses increased \$0.3 million, or 0.7%, to \$45.1 million, as compared to \$44.8 million for the three months ended June 30, 2009 as the additional expenses from stand alone acquisitions of \$2.6 million and an increase in insurance expense of \$0.4 million more than offset a decline in delivery and branch expenses in the base business of \$2.7 million. Bad debt expense declined by \$1.4 million as our account losses related to credit issues fell by 51.5%. Delivery and branch expenses were also favorably impacted by \$0.8 million due to the decline in home heating oil volume of 18.9% and \$0.5 million in lower vehicle fuel cost.

**Depreciation and Amortization**

For the three months ended June 30, 2010, depreciation and amortization expenses increased by \$0.3 million or 9.1%, to \$4.1 million as compared to \$3.8 million for the three months ended June 30, 2009, due to additional amortization expense from acquisitions.

**General and Administrative Expenses**

For the three months ended June 30, 2010, general and administrative expenses increased by \$0.5 million or 8.4%, to \$5.8 million, from \$5.3 million for the three months ended June 30, 2009 primarily due to legal and professional fees relating to acquisitions of \$0.6 million.

**Operating Income (Loss)**

For the three months ended June 30, 2010, operating income decreased \$14.8 million to an operating loss of \$13.9 million, from an operating profit of \$0.9 million for the three months ended June 30, 2009, as an unfavorable non-cash change in the fair value of derivative instruments of \$12.0 million, a decline in product gross profit of \$4.5 million and higher delivery and branch expenses of \$0.3 million more than offset the improvement in installation and service gross profit of \$2.7 million.





## **Table of Contents**

### **Interest Expense**

For the three months ended June 30, 2010, interest expense decreased by \$1.0 million, or 24.7% to \$3.1 million as compared to \$4.1 million for the three months ended June 30, 2009. Over the last fifteen months, the Partnership has repurchased \$54.0 million face value of its 10.25% Senior Notes, which lowered the average long-term debt outstanding by \$54 million and the corresponding interest expense by \$1.4 million. Bank charges increased by \$0.3 million largely due to an increase in letter of credit fees.

### **Interest Income**

For the three months ended June 30, 2010, interest income increased \$0.1 million, or 8.9%, to \$1.4 million, as compared to \$1.3 million for the three months ended June 30, 2009, due to an increase in finance charge income on past due accounts receivable balances.

### **Amortization of Debt Issuance Costs**

For the three months ended June 30, 2010, amortization of debt issuance costs increased \$0.1 million to \$0.6 million, as compared to \$0.5 million for the three months ended June 30, 2009.

### **Income Tax Expense (Benefit)**

For the three months ended June 30, 2010 the Partnership's income tax benefit increased \$5.7 million to \$6.2 million, from \$0.5 million for the three months ended June 30, 2009. This increase was due primarily to an increase in deferred income tax benefit of \$5.4 million and an increase in the current tax benefit of \$0.3 million. The Partnership had a full valuation allowance and any deferred tax benefits for the three months ended June 30, 2009 were fully offset by the valuation allowance, leaving only a current tax benefit. As much of the valuation allowance was released as of September 30, 2009, the tax benefit for the three months ended June 30, 2010 consisted of both a \$0.8 million current tax benefit and a \$5.4 million deferred tax benefit.

### **Net Income (Loss)**

For the three months ended June 30, 2010, the Partnership generated a net loss of \$10.0 million, as compared to net loss of \$1.9 million for the three months ended June 30, 2009. This increase in the net loss of \$8.1 million was primarily due to an increase on the loss before income taxes of \$13.8 million reduced by an increase in deferred income tax benefit of \$5.4 million and an increase in current tax benefit of \$0.3 million.

**Table of Contents****Adjusted EBITDA**

For the three months ended June 30, 2010, the Adjusted EBITDA loss was \$7.5 million, \$2.5 million greater than the Adjusted EBITDA loss of \$5.0 million generated during the three months ended June 30, 2009, as the impact of the decline in home heating oil volume more than offset the impact of higher per gallon margins. In addition, stand alone acquisitions and related expenses generated an Adjusted EBITDA loss of \$0.9 million.

(in thousands)	Three Months Ended	
	June 30,	
	2010	2009
Net loss	\$ (9,991)	\$ (1,924)
Plus:		
Income tax benefit	(6,232)	(498)
Amortization of debt issuance cost	660	564
Interest expense, net	1,682	2,814
Depreciation and amortization	4,083	3,744
<b>EBITDA from continuing operations</b>	<b>(9,798)</b>	<b>4,700</b>
(Increase) / decrease in the fair value of derivative instruments	2,324	(9,656)
<b>Adjusted EBITDA</b>	<b>(7,474)</b>	<b>(4,956)</b>
<b>Add / (subtract)</b>		
Income tax benefit	6,232	498
Interest expense, net	(1,682)	(2,814)
Provision for losses on accounts receivable	1,088	2,371
Decrease in accounts receivables	93,573	75,933
Increase in inventories	(565)	(15,993)
Increase in customer credit balances	8,673	11,586
Change in deferred taxes	(5,420)	
Change in other operating assets and liabilities	(4,130)	(19,176)
<b>Net cash provided by (used in) operating activities</b>	<b>\$ 90,295</b>	<b>\$ 47,449</b>
<b>Net cash used in investing activities</b>	<b>\$ (68,555)</b>	<b>\$ (814)</b>
<b>Net cash used in financing activities</b>	<b>\$ (31,362)</b>	<b>\$ (5,137)</b>

- (a) EBITDA (Earnings from continuing operations before net interest expense, income taxes, depreciation and amortization) and Adjusted EBITDA are non-GAAP financial measures that are used as supplemental financial measures by management and external users of our financial statements, such as investors, commercial banks and research analysts, to assess:

our compliance with certain financial covenants included in our debt agreements;

our financial performance without regard to financing methods, capital structure, income taxes or historical cost basis;

## Edgar Filing: STAR GAS FINANCE CO - Form 10-Q

our ability to generate cash sufficient to pay interest on our indebtedness and to make distributions to our partners;

our operating performance and return on invested capital as compared to those of other companies in the retail distribution of refined petroleum products business, without regard to financing methods and capital structure; and

the viability of acquisitions and capital expenditure projects and the overall rates of return of alternative investment opportunities.

Adjusted EBITDA is calculated as earnings from continuing operations before net interest expense, income taxes, depreciation and amortization, the (increase) decrease in the fair value of derivatives, gain or loss on debt redemption, goodwill impairment, and other non-cash and non-operating charges. Management believes the presentation of this measure

**Table of Contents**

is relevant and useful because it allows investors to view the Partnership's performance in a manner similar to the method management uses, and makes it easier to compare its results with other companies that have different financing and capital structures. In addition, this measure is consistent with the manner in which the Partnership's debt covenants in its material debt agreements are calculated. Both the Partnership's 10.25% Senior Note agreement and its bank credit facility contain covenants that restrict equity distributions, acquisitions, and the amount of debt it can incur. Under the most restrictive of these covenants, which is found in the bank credit facility, the agent bank could step in and control all cash transactions for the Partnership if we failed to comply with the minimum Availability or the fixed charge coverage ratio. The Partnership is required to maintain either availability (borrowing base less amounts borrowed and letters of credit issued) of \$43.5 million (15% of the maximum facility size) or a fixed charge coverage ratio of 1.1x (Adjusted EBITDA being a significant component of this calculation). This method of calculating Adjusted EBITDA may not be consistent with that of other companies and should be viewed in conjunction with measurements that are computed in accordance with GAAP.

Each of EBITDA and Adjusted EBITDA has its limitations as an analytical tool, and it should not be considered in isolation or as a substitute for analysis of our results as reported under GAAP. Some of the limitations of EBITDA and

Adjusted EBITDA are:

EBITDA and Adjusted EBITDA do not reflect our cash used for capital expenditures;

Although depreciation and amortization are non-cash charges, the assets being depreciated or amortized often will have to be replaced, and EBITDA and Adjusted EBITDA do not reflect the cash requirements for such replacements;

EBITDA and Adjusted EBITDA do not reflect changes in, or cash requirements for, our working capital requirements;

EBITDA and Adjusted EBITDA do not reflect the cash necessary to make payments of interest or principal on our indebtedness; and

EBITDA and Adjusted EBITDA do not reflect the cash required to pay taxes.

**Table of Contents****Nine Months Ended June 30, 2010****Compared to the Nine Months Ended June 30, 2009****Volume**

(in millions of gallons)	Heating Oil
Volume - Nine months ended June 30, 2009	328.5
Impact of warmer temperatures	(29.8)
Net customer attrition - residential / commercial	(13.2)
Acquisitions	1.4
Other	0.2
 Change	 (41.4)
 Volume - Nine months ended June 30, 2010	 287.1

For the nine months ended June 30, 2010, retail volume of home heating oil decreased by 41.4 million gallons, or 12.6%, to 287.1 million gallons, as compared to 328.5 million gallons for the nine months ended June 30, 2009. An analysis of the change in the retail volume of home heating oil, which is based on management's estimates, sampling and other mathematical calculations, is found below:

Temperatures in our geographic areas of operations for the nine months ended June 30, 2010 were 9.1% warmer than the nine months ended June 30, 2009 and approximately 7.9% warmer than normal, as reported by the NOAA. Between July 1, 2009 and June 30, 2010, net customer attrition was 4.8%, and the above table reflects the lost volume related to this net customer attrition. Due to the significant increase in the price per gallon of home heating oil over the last several years, we believe that customers are using less home heating oil given similar temperatures when compared to prior periods.

Volume of other petroleum products for the nine months ended June 30, 2010 decreased by 2.9 million gallons, or 8.8%, to 29.5 million gallons, as compared to 32.4 million gallons of other petroleum products sold during the nine months ended June 30, 2009. While volume of other petroleum products sold by our stand alone acquisitions did increase by 1.4 million gallons, the effect of competitive pressures, selective reductions in our customer base due to increases in both our credit and profitability standards and the downturn in the economy resulted in a decline in other product volume sales of 4.3 million gallons.

The percentage of heating oil volume sold to residential variable price customers increased to 42.1% for the nine months ended June 30, 2010, as compared to 40.3% for the nine months ended June 30, 2009. The percentage of heating oil volume sold to residential price-protected customers decreased to 44.2% for the nine months ended June 30, 2010, as compared to 45.5% for the nine months ended June 30, 2009. For the nine months ended June 30, 2010, sales to commercial/industrial customers decreased to 13.7% of total heating oil volume sales, as compared to 14.2% for the nine months ended June 30, 2009.

**Product Sales**

For the nine months ended June 30, 2010, product sales decreased \$16.8 million, or 1.7%, to \$942.6 million, as compared to \$959.4 million for the nine months ended June 30, 2009, as the reduction in volume of home heating oil and other petroleum products sold was largely offset by higher selling prices. Selling prices rose in response to an increase in per gallon wholesale product costs.

**Installation and Service Sales**

For the nine months ended June 30, 2010, service and installation sales increased \$3.1 million, or 2.3%, to \$134.7 million, as compared to \$131.6 million for the nine months ended June 30, 2009, as the additional service and installation revenue from acquisitions of \$2.1 million and higher air conditioning installation and service revenue of \$2.5 million was slightly offset by a \$0.3 million reduction in heating installations. Heating service contract revenue also declined by \$1.0 million due to the impact of net customer attrition.



**Table of Contents****Cost of Product**

For the nine months ended June 30, 2010, cost of product increased \$11.1 million, or 1.7%, to \$669.6 million, as compared to \$658.5 million for the nine months ended June 30, 2009, as the increase in per gallon wholesale product cost for all products exceeded the decline in volume.

**Gross Profit Product**

The table below calculates the Partnership's per gallon margins and reconciles product gross profit for home heating oil and other petroleum products. We believe the change in home heating oil margins should be evaluated before the effects of increases or decreases in the fair value of derivative instruments, as we believe that realized per gallon margins should not include the impact of non-cash changes in the market value of hedges before the settlement of the underlying transaction. On that basis, home heating oil margins for the nine months ended June 30, 2010 increased by \$0.0328 per gallon, or 3.7%, to \$0.9185 per gallon, from \$0.8857 per gallon in the nine months ended June 30, 2009. Product sales and cost of product include home heating oil, other petroleum products and liquidated damages billings.

	Nine Months Ended			
	June 30, 2010		June 30, 2009	
	Amount (000)	Per Gallon	Amount (000)	Per Gallon
<b>Home Heating Oil</b>				
Volume (in gallons)	287,090		328,507	
Sales	\$ 871,978	\$ 3.0373	\$ 896,604	\$ 2.7293
Cost	608,294	2.1188	605,649	1.8436
Gross Profit	\$ 263,684	\$ 0.9185	\$ 290,955	\$ 0.8857
	Amount (000)	Per Gallon	Amount (000)	Per Gallon
<b>Other Petroleum Products</b>				
Volume (in gallons)	29,527		32,380	
Sales	\$ 70,668	\$ 2.3933	\$ 62,829	\$ 1.9404
Cost	61,279	2.0754	52,862	1.6326
Gross Profit	\$ 9,389	\$ 0.3180	\$ 9,967	\$ 0.3077
	Amount (000)		Amount (000)	Change
<b>Total Product</b>				
Sales	\$ 942,646		\$ 959,433	\$ (16,787)
Cost	\$ 669,573		658,511	(11,060)
Gross Profit	\$ 273,073		\$ 300,922	\$ (27,847)

For the nine months ended June 30, 2010, total product gross profit decreased by \$27.8 million to \$273.1 million, as compared to \$300.9 million for the nine months ended June 30, 2009, as the impact of lower home heating oil volume (\$36.7 million) was partially offset by higher home heating oil per gallon margins (\$9.4 million). In addition, gross profit attributable to the sales of other petroleum products declined by \$0.5 million.





**Table of Contents****(Increase) Decrease in the Fair Value of Derivative Instruments**

During the nine months ended June 30, 2010, the increase in the fair value of derivative instruments resulted in the recording of a \$5.8 million credit due to the expiration of certain hedged positions or their realization to cost of product (\$6.5 million credit) and a decrease in the market value for unexpired hedges (\$0.7 million debit).

During the nine months ended June 30, 2009, the decrease in the fair value of derivative instruments resulted in the recording of a \$15.1 million credit due to the expiration of certain hedged positions or their realization to cost of product (\$19.9 million credit), and an increase in the market value for unexpired hedges (\$4.8 million charge).

**Cost of Installations and Service**

During the nine months ended June 30, 2010, cost of installations and service decreased \$2.5 million, or 1.9%, to \$128.3 million, as compared to \$130.8 million for the nine months ended June 30, 2009 as the additional expenses from the stand alone acquisitions of \$1.6 million was more than offset by lower vehicle fuel expense of \$2.9 million and management's efforts to reduce costs in line with net customer attrition. Management views the service and installation department on a combined basis because many expenses cannot be separated or allocated to either service or installation billings. Many overhead functions and direct expenses such as service technician time cannot be precisely allocated.

Installation costs were \$40.2 million, or 85.2% of installation sales during the nine months ended June 30, 2010, and were \$40.4 million, or 89.0% of installation sales during the nine months ended June 30, 2009. The decline in installation costs as a percentage of sales was largely the result of reduced staffing levels as the Partnership responded to the impact on installation sales of the current economic downturn. In the nine months ended June 30, 2009, the Partnership did not reduce staffing levels as quickly as the decline in installation revenue. Service expenses decreased to \$88.1 million, or 100.7% of service sales during the nine months ended June 30, 2010, from \$90.4 million in the nine months ended June 30, 2009, or 104.8% of sales. The decrease in service expenses of \$2.3 million was largely due to the \$2.9 million decline in vehicle fuel costs partially offset by additional service costs for acquisitions of \$0.9 million. The decline in service costs as a percentage of service revenue was due to higher profitability of the increased air conditioning service, the decline in vehicle fuels, and the fact that our recent acquisitions have a lower cost as a percentage of service revenue. For the nine months ended June 30, 2010, a net gross profit from service and installation of \$6.4 million was generated, as compared to a net gross profit of \$0.8 million for the nine months ended June 30, 2009.

**Delivery and Branch Expenses**

For the nine months ended June 30, 2010, delivery and branch expenses decreased \$11.1 million, or 6.2%, to \$169.8 million, as compared to \$180.9 million for the nine months ended June 30, 2009. Account losses due to credit declined by 51.5% which drove a decline in bad debt expense of \$2.8 million, while vehicle fuel expenses fell by \$3.3 million due to a decline in fuel costs. Insurance expense was lower by \$3.6 million due to a decline in the cost of the Partnership's weather hedge (\$1.8 million) and lower premium and estimated claims experience (\$1.4 million). Delivery and branch expenses were also favorably impacted by \$4.1 million due to the decline in home heating oil volume which mitigated the impact of inflationary pressures on operating expenses. The operations of stand alone acquisitions added \$2.6 million in delivery and branch expenses. On a cents per gallon basis, delivery and branch expenses increased 4.0 cents per gallon or 7.4%, from 55.1 cents for the nine months ended June 30, 2009 to 59.1 cents for the nine months ended June 30, 2010 due to the fixed nature of certain operating expenses that could not be adjusted due to the 12.6% decline in home heating oil volume.

**Depreciation and Amortization**

For the nine months ended June 30, 2010, depreciation and amortization expenses declined by \$4.7 million, or 29.5%, to \$11.2 million, as compared to \$15.9 million for the nine months ended June 30, 2009. Amortization expense was lower by \$4.2 million, as acquisitions from 1999 with a 10 year life became fully amortized in fiscal 2009.

**General and Administrative Expenses**

For the nine months ended June 30, 2010, general and administrative expenses increased \$0.8 million to \$16.4 million, as compared to \$15.6 million for the nine months ended June 30, 2009. Legal and professional expenses relating to acquisitions increased by \$0.6 million and pension expense relating to the Partnership's frozen pension plan increased by \$0.6 million as well.

## **Table of Contents**

### **Operating Income (Loss)**

For the nine months ended June 30, 2010, operating income decreased \$16.6 million to \$87.9 million, from income of \$104.5 million for the nine months ended June 30, 2009, as a decrease in product gross profit of \$27.8 million and an unfavorable change in the fair value of derivative instruments of \$9.3 million were somewhat offset by lower operating costs (net service, delivery, general and administrative and depreciation and amortization) of \$20.5 million.

### **Interest Expense**

For the nine months ended June 30, 2010, interest expense decreased by \$2.2 million, or 16.5 % to \$11.3 million as compared to \$13.5 million for the nine months ended June 30, 2009. Over the last twenty-one months, the Partnership repurchased \$90.3 million face value of its 10.25% Senior Notes lowering the average long-term debt outstanding for these notes by \$41.9 million and corresponding interest expense by \$3.2 million. Bank charges increased by \$0.8 million due to an increase in letter of credit fees.

During the nine months ended June 30, 2010, average bank borrowings were \$4.8 million and corresponding interest expense increased by \$0.2 million.

During the nine months ended June 30, 2009, the Partnership did not borrow under its bank facility.

### **Interest Income**

For the nine months ended June 30, 2010, interest income decreased \$0.8 million, or 23.5%, to \$2.8 million, as compared to \$3.6 million for the nine months ended June 30, 2009, due to lower invested cash balances and lower finance charge income on past due accounts receivables balances.

### **Amortization of Debt Issuance Costs**

For the nine months ended June 30, 2010, amortization of debt issuance costs increased \$0.3 million, or 14.8% to \$2.0 million, as compared to \$1.7 million for the nine months ended June 30, 2009.

### **Gains (Loss) on Bond Repurchase**

During the nine months ended June 30, 2010, the Partnership purchased \$50.0 million face value of its 10.25% Senior Notes due February 2013 at an average price of \$101.7 per \$100 of principal plus accrued interest. The Partnership recorded a loss of \$1.1 million.

During the nine months ended June 30, 2009, the Partnership repurchased \$36.3 million face value of its 10.25% Senior Notes due February 2013 at an average price of \$72.4 per \$100 of principal plus accrued interest. The Partnership recorded a gain of \$9.7 million.

### **Income Tax Expense (Benefit)**

For the nine months ended June 30, 2010, income tax expense increased \$29.8 million, to \$33.7 million, from \$3.9 million for the nine months ended June 30, 2009. This increase is due to an increase in deferred tax expense of \$30.4 million. Due to the Partnership having a full valuation allowance as of June 30, 2009, any deferred tax benefits as of June 30, 2009 were fully offset by the valuation allowance, leaving only a current tax expense. As much of the valuation allowance was released as of September 30, 2009, the tax expense for the nine months ended June 30, 2010 consists of both a \$3.3 million current tax expense and a \$30.4 million deferred tax expense.

### **Net Income**

For the nine months ended June 30, 2010, the Partnership generated net income of \$42.5 million, as compared to net income of \$98.7 million for the nine months ended June 30, 2009. This decrease in net income of \$56.2 million was attributable to a decrease in income before income taxes of \$26.4 million, an increase in deferred income tax of \$30.4 million and a decrease in current income tax expense of \$0.6 million.

**Table of Contents****Adjusted EBITDA**

For the nine months ended June 30, 2010, Adjusted EBITDA decreased by \$12.0 million to \$93.3 million, as compared to \$105.3 million for the nine months ended June 30, 2009, as the impact of warmer temperatures and net customer attrition on home heating oil volume more than offset the effects of higher per gallon margins and lower operating costs. In addition, Adjusted EBITDA was reduced by \$0.9 million due to stand alone acquisitions and related expenses.

(in thousands)	Nine Months Ended	
	2010	2009
Net income	\$ 42,549	\$ 98,732
Plus:		
Income tax expense	33,681	3,852
Amortization of debt issuance cost	1,988	1,732
Interest expense, net	8,508	9,894
Depreciation and amortization	11,179	15,853
<b>EBITDA from continuing operations</b>	<b>97,905</b>	<b>130,063</b>
(Increase) / decrease in the fair value of derivative instruments	(5,770)	(15,064)
(Gains) / loss on redemption of debt	1,132	(9,740)
<b>Adjusted EBITDA</b>	<b>93,267</b>	<b>105,259</b>
<b>Add / (subtract)</b>		
Income tax expense	(33,681)	(3,852)
Interest expense, net	(8,508)	(9,894)
Provision for losses on accounts receivable	6,570	9,257
(Increase) decrease in accounts receivables	(41,717)	4,350
(Increase) decrease in inventories	1,871	(10,595)
Decrease in customer credit balances	(44,425)	(24,806)
Change in deferred taxes	30,368	
Change in other operating assets and liabilities	10,502	11,089
<b>Net cash provided by operating activities</b>	<b>\$ 14,247</b>	<b>\$ 80,808</b>
<b>Net cash used in investing activities</b>	<b>\$ (71,187)</b>	<b>\$ (5,655)</b>
<b>Net cash used in financing activities</b>	<b>\$ (94,269)</b>	<b>\$ (36,545)</b>

- (a) EBITDA (Earnings from continuing operations before net interest expense, income taxes, depreciation and amortization) and Adjusted EBITDA are non-GAAP financial measures that are used as supplemental financial measures by management and external users of our financial statements, such as investors, commercial banks and research analysts, to assess:

our compliance with certain financial covenants included in our debt agreements;

our financial performance without regard to financing methods, capital structure, income taxes or historical cost basis;

## Edgar Filing: STAR GAS FINANCE CO - Form 10-Q

our ability to generate cash sufficient to pay interest on our indebtedness and to make distributions to our partners;

our operating performance and return on invested capital as compared to those of other companies in the retail distribution of refined petroleum products business, without regard to financing methods and capital structure; and

the viability of acquisitions and capital expenditure projects and the overall rates of return of alternative investment opportunities.

Adjusted EBITDA is calculated as earnings from continuing operations before net interest expense, income taxes, depreciation and amortization, the (increase) decrease in the fair value of derivatives, gain or loss on debt redemption, goodwill impairment, and other non-cash and non-operating charges. Management believes the presentation of this measure

---

## **Table of Contents**

is relevant and useful because it allows investors to view the Partnership's performance in a manner similar to the method management uses, and makes it easier to compare its results with other companies that have different financing and capital structures. In addition, this measure is consistent with the manner in which the Partnership's debt covenants in its material debt agreements are calculated. Both the Partnership's 10.25% Senior Note agreement and its bank credit facility contain covenants that restrict equity distributions, acquisitions, and the amount of debt it can incur. Under the most restrictive of these covenants, which is found in the bank credit facility, the agent bank could step in and control all cash transactions for the Partnership if we failed to comply with the minimum Availability or the fixed charge coverage ratio. The Partnership is required to maintain either availability (borrowing base less amounts borrowed and letters of credit issued) of \$43.5 million (15% of the maximum facility size) or a fixed charge coverage ratio of 1.1x (Adjusted EBITDA being a significant component of this calculation). This method of calculating Adjusted EBITDA may not be consistent with that of other companies and should be viewed in conjunction with measurements that are computed in accordance with GAAP.

Each of EBITDA and Adjusted EBITDA has its limitations as an analytical tool, and it should not be considered in isolation or as a substitute for analysis of our results as reported under GAAP. Some of the limitations of EBITDA and

Adjusted EBITDA are:

EBITDA and Adjusted EBITDA do not reflect our cash used for capital expenditures;

Although depreciation and amortization are non-cash charges, the assets being depreciated or amortized often will have to be replaced, and EBITDA and Adjusted EBITDA do not reflect the cash requirements for such replacements;

EBITDA and Adjusted EBITDA do not reflect changes in, or cash requirements for, our working capital requirements;

EBITDA and Adjusted EBITDA do not reflect the cash necessary to make payments of interest or principal on our indebtedness; and

EBITDA and Adjusted EBITDA do not reflect the cash required to pay taxes.

## **DISCUSSION OF CASH FLOWS**

We use the indirect method to prepare our Consolidated Statements of Cash Flows. Under this method, we reconcile net income to cash flows provided by operating activities by adjusting net income for those items that impact net income but may not result in actual cash receipts or payment during the period.

### ***Operating Activities***

Due to the seasonal nature of the home heating oil business, cash is generally used in operations during the winter (our first and second fiscal quarters) as customers receive deliveries and pay for products purchased within our payment terms, and cash is generally provided by operating activities during the spring and summer (our third and fourth quarters) when customer payments exceed deliveries. For the nine months ended June 30, 2010, cash provided by operating activities was \$14.2 million, as compared to \$80.8 million of cash provided by operating activities during the nine months ended June 30, 2009. This change of \$66.6 million was largely due to a decline in cash received from budget payment plan customers of \$38.1 million. Approximately 34% of our customers are on a budget payment plan and these customers pay their annual estimated heating bill in 12 monthly installments. Typically, these plans begin before the heating season and a liability is created as payments exceed deliveries. During the nine months ended June 30, 2009, cash received from these customers benefited from a declining home heating oil market as payment plans for these customers had been set prior to the precipitous drop in the cost of home heating oil. This resulted in an increase in collections from budget payment plan customers versus expected deliveries for the nine months ended June 30, 2009. The Partnership's accounts receivables for non-budget customers also rose by \$27.6 million more in the nine months ended June 30, 2010, versus the nine months ended June 30, 2009, due to the above described market conditions as amounts due from customers rose with the increase in heating oil prices. Days sales outstanding increased to 57 days as of June 30, 2010 as compared to 48 days as of June 30, 2009 and 57 days as of June 30, 2008. During the nine months ended June 30, 2010, the Partnership bought 24.3 million gallons less of home heating oil for inventory than the nine months ended June 30, 2009, which drove a favorable change in cash flows of \$12.4 million. At the beginning of fiscal 2009, the

## Edgar Filing: STAR GAS FINANCE CO - Form 10-Q

Partnership's physical inventory of home heating oil was relatively low because the Partnership did not prebuy physical inventory due to the relatively high cost at the time. The change in inventory was also impacted by price. During the nine months ended June 30, 2010 inventory costs increased by \$0.41 per gallon as compared to the prior period which experienced a reduction in inventory cost of \$1.72 per gallon. In addition, cash flow generated from operations declined by \$12.5 million for the nine months ended June 30, 2010, when compared to the nine months ended June 30, 2009.

---

## **Table of Contents**

### ***Investing Activities***

During the nine months ended June 30, 2010, we completed acquisitions for \$67.8 million, including working capital of \$4.0 million. We allocated \$65.6 million of the gross purchase price to intangible assets and \$7.2 million to fixed assets and recorded a deferred tax liability of \$9.0 million. In addition, capital expenditures totaled \$3.6 million, as we invested in computer hardware and software (\$1.6 million), refurbished certain physical plants (\$0.4 million) and made additions to our fleet and other equipment (\$1.6 million).

During the nine months ended June 30, 2009, our capital expenditures totaled \$2.5 million, as we invested in computer hardware and software (\$0.8 million), refurbished certain physical plants (\$0.4 million) and made additions to our fleet (\$1.3 million). We also completed one acquisition for \$3.3 million, net of working capital credits of \$0.7 million. We allocated \$3.4 million of the gross purchase to intangible assets and \$0.6 million to fleet.

### ***Financing Activities***

During the nine months of fiscal 2010, the Partnership repurchased 6.9 million common units for \$27.9 million in connection with the unit repurchase plan program and paid distributions to the unit holders of \$15.4 million. During the nine months ended June 30, 2010, we borrowed and repaid \$36.8 million under our revolving credit facility. In February 2010, the Partnership redeemed \$50.0 million face value of its outstanding 10.25% Senior Notes due in 2013 at a price equal to 101.708% of face value.

During the nine months ended June 30, 2009, the Partnership repurchased \$36.3 million face value of its outstanding 10.25% Senior Notes due February 2013 for \$26.3 million. In addition, we commenced distributions in February, 2009 at a rate of \$0.0675 per unit (subsequently raised to \$0.0725 in January 2010) and paid \$10.3 million in distributions during the nine months ended June 30, 2009.

### ***Liquidity and Capital Resources***

Our ability to satisfy our financial obligations depends on our future performance, which will be subject to prevailing economic, financial, business and weather conditions, the ability to pass on the full impact of high wholesale heating oil prices to customers, the effects of high net customer attrition, conservation and other economic and geo-political factors, most of which are beyond our control. Approximately 77% of the Partnership's protected price customers have agreements with us that are subject to annual renewal in the period from April through November of each fiscal year. If a significant number of these customers elect not to renew their protected price agreements with us and do not continue as our customers under a variable price-plan, the Partnership's near term liquidity and cash flow will be adversely impacted. Based on the recent prices, these price-protected customers will be offered renewal contracts at higher prices than last year which may adversely impact the acceptance rate of these renewals.

In the near term, our capital requirements are expected to be provided by cash flows from operating activities, cash on hand as of June 30, 2010, or a combination thereof. To the extent future capital requirements exceed cash on hand plus cash flows from operating activities, we anticipate that working capital will be financed by our revolving credit facility.

Our asset based revolving credit facility provides us with the ability to borrow up to \$240.0 million (\$290.0 million during the heating season from November through April of each year) for working capital purposes (subject to certain borrowing base limitations and coverage ratios), including the issuance of up to \$100.0 million in letters of credit which reduce availability under this facility. The Partnership can increase the facility size by \$50.0 million without the consent of the bank group. However, the bank group is not obligated to fund the \$50.0 million increase. If the bank group elects not to fund the increase, the Partnership can add additional lenders to the group, with the consent of the Agent, which shall not be unreasonably withheld. Obligations under the revolving credit facility are secured by liens on substantially all of our assets including accounts receivable, inventory, general intangibles, real property, fixtures and equipment. As of June 30, 2010 \$42.3 million in letters of credit were outstanding, of which \$42.1 million are for current and future insurance reserves and bonds. We have reduced our reliance on letters of credit for inventory purchases as we have increased our trade credit to over \$37.4 million.

Under the terms of the credit facility, we must maintain at all times either availability (borrowing base less amounts borrowed and letters of credit issued) of \$43.5 million (15% of the maximum facility size) or a fixed charge coverage ratio (as defined in the credit agreement) of not less than 1.10x. As of June 30, 2010, availability, as defined in the amended and restated credit agreement, was \$112.8 million and the Partnership was in compliance with the fixed charge coverage ratio. The fixed charge coverage ratio is calculated based upon Adjusted EBITDA. In the event that the Partnership is not able to comply with these covenants it could have a material adverse effect on the Partnership's liquidity and results of its operations.





---

## **Table of Contents**

The Partnership's scheduled interest payments on our 10.25% Senior Notes for the remainder of fiscal 2010 are \$4.2 million and maintenance capital expenditures for fixed assets for the balance of fiscal 2010 are estimated to be approximately \$0.5 to \$1.0 million, excluding the capital requirements for leased fleet. We estimate that the Partnership will make cash contributions to fund its frozen defined benefit pension obligations of approximately \$11.9 million for the balance of fiscal 2010. We recently announced that we will pay a distribution of approximately \$5.0 million in August 2010.

The Partnership intends to continue to make additional business acquisitions during the balance of fiscal 2010 and in fiscal 2011 of home heating oil and other businesses that meet the Partnership's acquisition criteria, subject to the availability of financing, either internally generated or from other sources, for such acquisitions.

### ***Partnership Distribution Provisions***

We are required to make distributions in an amount equal to our Available Cash, as defined in our Partnership Agreement, no more than 45 days after the end of each fiscal quarter, to holders of record on the applicable record dates. Available Cash, as defined in our Partnership Agreement, generally means all cash on hand at the end of the relevant fiscal quarter less the amount of cash reserves established by the Board of Directors of our general partner in its reasonable discretion for future cash requirements. These reserves are established for the proper conduct of our business, including acquisitions, the payment of debt principal and interest and for distributions during the next four quarters and to comply with applicable laws and the terms of any debt agreements or other agreements to which we are subject. Under the terms of our credit facility, the Partnership must have a fixed charge coverage ratio for the trailing twelve months of 1.15x to pay the minimum quarterly distribution of \$0.0675. Any distribution in excess of the minimum quarterly distribution requires the Partnership to have a fixed charge coverage ratio of 1.25x. These tests restrict the amount of cash that the Partnership can use to pay distributions with respect to any fiscal quarter. The Board of Directors of our general partner reviews the level of Available Cash each quarter based upon information provided by management.

On July 19, 2010, the Partnership declared a quarterly distribution of \$0.0725 on all of its common units, payable on August 13 to holders of record on August 5, 2010.

### ***Contractual Obligations and Off-Balance Sheet Arrangements***

There has been no material change to Contractual Obligations and Off-Balance Sheet Arrangements since September 30, 2009, and therefore, the table has not been included in this Form 10-Q.

### ***Recent Accounting Pronouncements***

In the first quarter of fiscal 2010, the Partnership adopted the provisions of FASB ASC 805-10 Business Combinations (SFAS No. 141R). This standard establishes in a business combination principles and requirements for how an acquirer recognizes and measures identifiable assets acquired, goodwill acquired, liabilities assumed, and any noncontrolling interests.

## **Item 3.**

### **Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to interest rate risk primarily through our bank credit facilities. We utilize these borrowings to meet our working capital needs.

At June 30, 2010, we had outstanding borrowings totaling \$82.5 million (excluding discounts and premiums), none of which is subject to variable interest rates.

We also selectively use derivative financial instruments to manage our exposure to market risk related to changes in the current and future market price of home heating oil. The value of market sensitive derivative instruments is subject to change as a result of movements in market prices. Sensitivity analysis is a technique used to evaluate the impact of hypothetical market value changes. Based on a hypothetical ten percent increase in the cost of product at June 30, 2010, the potential impact on our hedging activity would be to increase the fair market value of these outstanding derivatives by \$2.2 million to a fair market value of \$8.7 million; and conversely a hypothetical ten percent decrease in the cost of product would decrease the fair market value of these outstanding derivatives by \$(0.4) million to a fair market value of \$6.1 million.



---

**Table of Contents**

**Item 4.**

**Controls and Procedures**

(a) Evaluation of disclosure controls and procedures.

The General Partner's principal executive officer and its principal financial officer evaluated the effectiveness of the Partnership's disclosure controls and procedures (as that term is defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended) as of June 30, 2010. Based on that evaluation, such principal executive officer and principal financial officer concluded that the Partnership's disclosure controls and procedures were effective as of June 30, 2010 at the reasonable level of assurance. For purposes of Rule 13a-15(e), the term *disclosure controls and procedures* means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Act (15 U.S.C. 78a et seq.) is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

(b) Change in Internal Control over Financial Reporting.

On May 10, 2010, the Company completed the acquisition of Champion Energy Corporation (CEC). The Company is in the early stages of integrating CEC. The Company is analyzing, evaluating and, where necessary, will implement changes in controls and procedures relating to the CEC business as integration proceeds. As a result, this process may result in additions or changes to our internal control over financial reporting. Otherwise, there was no change in the Partnership's internal control over financial reporting during the Partnership's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect the Partnership's internal control over financial reporting.

(c) The General Partner and the Partnership believe that a controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. Therefore, a control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Our disclosure controls and procedures are designed to provide such reasonable assurances of achieving our desired control objectives, and the principal executive officer and principal financial officer of our general partner have concluded, as of June 30, 2010, that our disclosure controls and procedures were effective in achieving that level of reasonable assurance.

**PART II OTHER INFORMATION**

**Item 1**

**Legal Proceedings**

In the opinion of management, we are not a party to any litigation, which individually or in the aggregate could reasonably be expected to have a material adverse effect on our results of operations, financial position or liquidity.

**Item 1A**

**Risk Factors**

An investment in the Partnership involves a high degree of risk, including the following factors:

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended September 30, 2009, which could



**Table of Contents**

materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing the Partnership. Other unknown or unpredictable factors could also have material adverse effects on future results.

**Item 2.**

**Unregistered Sales of Equity Securities and Use of Proceeds**

See Note 2. to the Consolidated Financial Statements for information concerning the Partnership's repurchase of common units in the nine months ended June 30, 2010.

**Item 6.**

**Exhibits**

(a) *Exhibits Included Within:*

- 10.1 Equity Purchase Agreement dated as of May 10, 2010 among Petro Holdings, Inc., PJC InterCapital LP, A. Silecchia Corporation, and PJC Group of New England Co.
- 31.1 Rule 13a-14(a) Certification, Star Gas Partners, L.P.
- 31.2 Rule 13a-14(a) Certification, Star Gas Finance Company
- 31.3 Rule 13a-14(a) Certification, Star Gas Partners, L.P.
- 31.4 Rule 13a-14(a) Certification, Star Gas Finance Company
- 32.1 Section 906 Certification.
- 32.2 Section 906 Certification.

**Table of Contents**

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrants have duly caused this report to be signed on its behalf of the undersigned thereunto duly authorized:

Star Gas Partners, L.P.

(Registrant)

By: Kestrel Heat LLC AS GENERAL PARTNER

Signature	Title	Date
/s/ RICHARD F. AMBURY  <b>Richard F. Ambury</b>	Executive Vice President, Chief Financial Officer, Treasurer and Secretary Kestrel Heat LLC (Principal Financial Officer)	August 3, 2010

Signature	Title	Date
/s/ RICHARD G. OAKLEY  <b>Richard G. Oakley</b>	Vice President - Controller  Kestrel Heat LLC (Principal Accounting Officer)	August 3, 2010

Star Gas Finance Company

(Registrant)

Signature	Title	Date
/s/ RICHARD F. AMBURY  <b>Richard F. Ambury</b>	Executive Vice President Chief Financial Officer, Treasurer and Secretary (Principal Financial Officer)	August 3, 2010

Signature	Title	Date
/s/ RICHARD G. OAKLEY  <b>Richard G. Oakley</b>	Vice President - Controller  (Principal Accounting Officer)	August 3, 2010