INERGY L P
Form 10-Q
May 07, 2009
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the quarterly period ended March 31, 2009**

**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: 0-32453**

# Inergy, L.P.

**(Exact name of registrant as specified in its charter)**

| **Delaware** | **43-1918951** |
|---|---|
| **(State or other jurisdiction of incorporation or organization)** | **(IRS Employer Identification No.)** |
| **Two Brush Creek Blvd., Suite 200** | |
| **Kansas City, Missouri** | **64112** |
| **(Address of principal executive offices)** | **(Zip code)** |

**(816) 842-8181**

**(Registrant s telephone number, including area code)**

**(Former name, former address and former fiscal year,**

**if changed since last report)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that registrant was required to submit and post such files). Yes ¨ No ¨

The following units were outstanding at May 1, 2009:

Common units 55,683,622

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**INERGY, L.P.**

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**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements of Inergy L.P.**

**INERGY L.P. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

***(in millions, except unit information)***

| | March 31, 2009 *(unaudited)* | September 30, 2008 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash | $ 18.1 | $ 17.3 |
| Accounts receivable, less allowance for doubtful accounts of $4.4 million and $6.4 million at March 31, 2009 and September 30, 2008, respectively | 143.9 | 128.5 |
| Inventories (*Note 3*) | 55.8 | 99.9 |
| Assets from price risk management activities | 34.3 | 33.3 |
| Prepaid expenses and other current assets | 21.4 | 21.9 |
| Total current assets | 273.5 | 300.9 |
| Property, plant and equipment (*Note 3*) | 1,372.1 | 1,275.0 |
| Less: accumulated depreciation | 282.8 | 244.7 |
| Property, plant and equipment, net | 1,089.3 | 1,030.3 |
| Intangible assets (*Note 3*): | | |
| Customer accounts | 269.4 | 266.7 |
| Other intangible assets | 132.6 | 127.0 |
| | 402.0 | 393.7 |
| Less: accumulated amortization | 117.6 | 105.5 |
| Intangible assets, net | 284.4 | 288.2 |
| Goodwill | 444.8 | 443.0 |
| Other assets | 9.8 | 4.0 |
| Total assets | $ 2,101.8 | $ 2,066.4 |
| **Liabilities and partners capital** | | |
| Current liabilities: | | |
| Accounts payable | $ 87.5 | $ 103.8 |
| Accrued expenses | 69.5 | 68.9 |
| Customer deposits | 29.3 | 87.7 |
| Liabilities from price risk management activities | 20.1 | 57.0 |
| Current portion of long-term debt (*Note 7*) | 10.4 | 60.5 |
| Total current liabilities | 216.8 | 377.9 |

| | | |
|---|---|---|
| Long-term debt, less current portion (*Note 7*) | 1,073.4 | 1,046.1 |
| Other long-term liabilities | 1.0 | 1.0 |
| Interest of non-controlling partners in ASC s subsidiaries | 4.4 | 3.6 |
| Partners capital (*Note 8*): | | |
| Common unitholders (55,264,123 and 50,715,074 units issued and outstanding as of March 31, 2009 and September 30, 2008, respectively) | 805.5 | 637.6 |
| Non-managing general partner and affiliate | 0.7 | 0.2 |
| Total partners capital | 806.2 | 637.8 |
| Total liabilities and partners capital | $ 2,101.8 | $ 2,066.4 |

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

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**INERGY, L.P. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

***(in millions, except unit and per unit data)***

***(unaudited)***

| | Three Months Ended March 31, 2009 | Three Months Ended March 31, 2008 | Six Months Ended March 31, 2009 | Six Months Ended March 31, 2008 |
|---|---|---|---|---|
| Revenue: | | | | |
| Propane | $ 443.9 | $ 526.1 | $ 853.1 | $ 928.7 |
| Other | 126.2 | 122.1 | 251.0 | 234.1 |
| | 570.1 | 648.2 | 1,104.1 | 1,162.8 |
| Cost of product sold (excluding depreciation and amortization as shown below): | | | | |
| Propane | 283.6 | 381.6 | 566.8 | 688.9 |
| Other | 74.4 | 78.0 | 150.9 | 148.1 |
| | 358.0 | 459.6 | 717.7 | 837.0 |
| Gross profit | 212.1 | 188.6 | 386.4 | 325.8 |
| Expenses: | | | | |
| Operating and administrative | 73.4 | 68.3 | 146.2 | 131.5 |
| Depreciation and amortization | 26.6 | 23.2 | 52.9 | 46.0 |
| Gain (loss) on disposal of assets | (2.3) | 0.1 | (3.0) | 1.2 |
| Operating income | 109.8 | 97.2 | 184.3 | 149.5 |
| Other income (expense): | | | | |
| Interest expense, net | (18.1) | (14.9) | (34.9) | (29.8) |
| Other income | | | | 0.1 |
| Income before income taxes and interest of non-controlling partners in ASC | 91.7 | 82.3 | 149.4 | 119.8 |
| Provision for income taxes | (0.1) | (0.1) | (0.2) | (0.4) |
| Interest of non-controlling partners in ASC s consolidated net income | (0.3) | (0.2) | (0.7) | (0.5) |
| Net income | $ 91.3 | $ 82.0 | $ 148.5 | $ 118.9 |
| Partners interest information: | | | | |
| Non-managing general partner and affiliates interest in net income | $ 11.8 | $ 9.4 | $ 22.5 | $ 17.9 |
| Distribution paid on restricted units | 0.2 | 0.1 | 0.3 | 0.2 |
| Total interest in net income not attributable to limited partners | $ 12.0 | $ 9.5 | $ 22.8 | $ 18.1 |
| Total limited partners interest in net income | $ 79.3 | $ 72.5 | $ 125.7 | $ 100.8 |
| Net income per limited partner unit: | | | | |
| Basic | $ 1.55 | $ 1.46 | $ 2.47 | $ 2.03 |

| | | | | |
|---|---|---|---|---|
| Diluted | $ 1.55 | $ 1.46 | $ 2.46 | $ 2.02 |
| | | | | |
| Weighted average limited partners units outstanding (*in thousands*): | | | | |
| Basic | 51,122 | 49,693 | 50,986 | 49,675 |
| Dilutive units | 31 | 77 | 21 | 96 |
| Diluted | 51,153 | 49,770 | 51,007 | 49,771 |

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

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**INERGY, L.P. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF PARTNERS CAPITAL**

***(in millions)***

***(unaudited)***

| | Common Unit Capital | Non-Managing General Partner and Affiliate | Total Partners Capital |
|---|---|---|---|
| Balance at September 30, 2008 | $ 637.6 | $ 0.2 | $ 637.8 |
| Net proceeds from issuance of common units | 85.6 | | 85.6 |
| Issuance of common units for acquisition | 6.7 | | 6.7 |
| Contribution from unit based compensation charges | 1.4 | | 1.4 |
| Retirement of common units | (0.8) | | (0.8) |
| Distributions | (65.5) | (22.1) | (87.6) |
| Comprehensive income: | | | |
| Net income | 126.0 | 22.5 | 148.5 |
| Change in unrealized fair value on cash flow hedges | 14.5 | 0.1 | 14.6 |
| Comprehensive income | | | 163.1 |
| Balance at March 31, 2009 | $ 805.5 | $ 0.7 | $ 806.2 |

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

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**INERGY, L.P. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

***(in millions)***

***(unaudited)***

| | Six Months Ended March 31, | |
|---|---|---|
| | **2009** | **2008** |
| **Operating activities** | | |
| Net income | $ 148.5 | $ 118.9 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 39.6 | 34.6 |
| Amortization | 13.3 | 11.4 |
| Amortization of deferred financing costs | 1.5 | 1.1 |
| Amortization of net bond discount | 0.3 | |
| Unit-based compensation charges | 1.4 | 0.8 |
| Interest of non-controlling partners in ASC s consolidated net income | 0.7 | 0.5 |
| Provision for doubtful accounts | 0.8 | 1.2 |
| (Gain) loss on disposal of assets | 3.0 | (1.2) |
| Changes in operating assets and liabilities, net of effects from acquisitions: | | |
| Accounts receivable | (15.7) | (72.8) |
| Inventories | 44.1 | 30.0 |
| Prepaid expenses and other current assets | 0.3 | 4.8 |
| Other liabilities | (0.2) | (0.3) |
| Accounts payable | (16.2) | (4.8) |
| Accrued expenses | 1.9 | (6.4) |
| Customer deposits | (58.4) | (42.9) |
| Net liabilities from price risk management activities | (23.3) | (9.3) |
| Net cash provided by operating activities | 141.6 | 65.6 |
| **Investing activities** | | |
| Acquisitions, net of cash acquired | (1.5) | (43.7) |
| Purchases of property, plant and equipment | (104.1) | (101.5) |
| Proceeds from sale of assets | 3.9 | 24.7 |
| Other | | (0.5) |
| Net cash used in investing activities | (101.7) | (121.0) |

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

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**INERGY, L.P. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)**

***(in millions)***

***(unaudited)***

| | Six Months Ended March 31, | |
|---|---|---|
| | **2009** | **2008** |
| **Financing activities** | | |
| Proceeds from the issuance of long-term debt | $ 596.9 | $ 395.8 |
| Principal payments on long-term debt | (628.5) | (250.5) |
| Distributions | (87.6) | (77.5) |
| Payments for deferred financing costs | (5.5) | |
| Net proceeds from unit options exercised | | 1.0 |
| Net proceeds from issuance of common units | 85.6 | |
| Net cash provided by (used in) financing activities | (39.1) | 68.8 |
| Net increase in cash | 0.8 | 13.4 |
| Cash at beginning of period | 17.3 | 7.7 |
| Cash at end of period | $ 18.1 | $ 21.1 |
| **Supplemental schedule of noncash investing and financing activities** | | |
| Additions to covenants not to compete through the issuance of noncompete obligations | $ 2.7 | $ 2.3 |
| Net change to property, plant and equipment through accounts payable and accrued expenses | $ (2.9) | $ 4.3 |
| Increase in the fair value of interest rate swap liability and related long-term debt | $ 5.8 | $ 7.6 |
| Acquisitions, net of cash acquired: | | |
| Current assets | $ 0.3 | $ 0.1 |
| Property, plant and equipment | 4.3 | 33.7 |
| Intangible assets, net | 2.5 | 5.2 |
| Goodwill | 1.8 | 22.7 |
| Other assets | | 0.6 |
| Current liabilities | (0.7) | (2.3) |
| Issuance of equity | (6.7) | |
| Other liabilities | | (16.3) |
| | $ 1.5 | $ 43.7 |

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

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**INERGY, L.P. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

***(unaudited)***

**Note 1 Partnership Organization and Basis of Presentation**

**Organization**

The consolidated financial statements of Inergy, L.P. ( Inergy , the Partnership or the Company ) include the accounts of Inergy and its subsidiaries, including Inergy Propane, LLC ( Inergy Propane ), Inergy Midstream, LLC (collectively, the Operating Companies ) and Inergy Finance Corp.

Inergy Partners, LLC ( Inergy Partners or the Non-Managing General Partner ), a subsidiary of Inergy Holdings, L.P. ( Holdings ), owns the Non-Managing General Partner interest in the Company. Inergy GP, LLC ( Inergy GP or the Managing General Partner ), a wholly-owned subsidiary of Holdings, has sole responsibility for conducting the Company s business and managing its operations. Holdings is a holding company whose principal business, through its subsidiaries, is its management of and ownership in the Company. Holdings also directly owns the incentive distribution rights ( IDR ) with respect to Inergy.

Pursuant to a partnership agreement, Inergy GP or any of its affiliates is entitled to reimbursement for all direct and indirect expenses incurred or payments it makes on behalf of Inergy and all other necessary or appropriate expenses allocable to Inergy or otherwise reasonably incurred by Inergy GP in connection with operating the Company s business. These costs, which totaled approximately $0.7 million and $1.4 million for the three months ended March 31, 2009 and 2008, and $1.9 million and $2.6 million for the six months ended March 31, 2009 and 2008, respectively, include compensation, bonuses and benefits paid to officers and employees of Inergy GP and its affiliates.

As of March 31, 2009, Holdings owns an aggregate 9.2% interest in Inergy, L.P., inclusive of ownership of all of the non-managing general partner and the managing general partner. This ownership is comprised of an approximate 0.8% general partnership interest and an approximate 8.4% limited partnership interest.

**Nature of Operations**

Inergy is engaged in the sale, distribution, marketing and trading of propane, natural gas and other natural gas liquids ( retail operations ). Inergy is also engaged in the storage, processing and fractionation of propane, natural gas and other natural gas liquids as well as the production and sale of salt ( midstream operations ). The retail propane market is seasonal because propane is used primarily for heating in residential and commercial buildings, as well as for agricultural purposes. Inergy s retail operations are primarily concentrated in the Midwest, Northeast, and South regions of the United States.

**Basis of Presentation**

The financial information contained herein as of March 31, 2009 and for the three-month and six-month periods ended March 31, 2009 and 2008 is unaudited. The Company believes this information has been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and Article 10 of Regulation S-X. The Company also believes this information includes all adjustments (consisting only of normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows for the periods then ended. The retail distribution business is largely seasonal due to propane s primary use as a heating source in residential and commercial buildings. Accordingly, the results of operations for the three-month and six-month periods ended March 31, 2009 are not indicative of the results of operations that may be expected for the entire fiscal year.

The accompanying consolidated financial statements should be read in conjunction with the consolidated financial statements of Inergy, L.P. and subsidiaries and the notes thereto included in Form 10-K as filed with the Securities and Exchange Commission for the fiscal year ended September 30, 2008.

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**INERGY, L.P. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

***(unaudited)***

**Reclassifications**

The consolidated statements of operations for the three and six months ended March 31, 2008 reflect a reclassification of transportation costs of $2.2 million and $4.1 million, respectively, from a component of operating and administrative expense to other cost of product sold. Certain prior period amounts have been reclassified to conform to the current period presentation. These reclassifications had no effect on net income.

**Note 2 Summary of Significant Accounting Policies**

**Financial Instruments and Price Risk Management**

Inergy utilizes certain derivative financial instruments to (i) manage its exposure to commodity price risk, specifically, the related change in the fair value of inventories, as well as the variability of cash flows related to forecasted transactions; (ii) ensure adequate physical supply of commodity will be available; and (iii) manage its exposure to interest rate risk associated with fixed rate borrowings. Inergy records all derivative instruments on the balance sheet as either assets or liabilities measured at fair value under the provisions of Statement of Financial Accounting Standards 133, Accounting for Derivative Instruments and Hedging Activities ( SFAS 133 ), as amended. Changes in the fair value of these derivative financial instruments are recorded either through current earnings or as other comprehensive income, depending on the type of transaction.

Inergy is party to certain commodity derivative financial instruments that are designated as hedges of selected inventory positions, and qualify as fair value hedges, as defined in SFAS 133. Inergy is also party to certain interest rate swap agreements designed to manage interest rate risk exposure. Inergy s overall objective for entering into fair value hedges is to manage its exposure to fluctuations in commodity prices and changes in the fair market value of its inventories and fixed rate borrowings. These derivatives are recorded at fair value on the balance sheets as price risk management assets or liabilities and the related change in fair value is recorded to earnings in the current period as cost of product sold.

Inergy also enters into derivative financial instruments that qualify as cash flow hedges, which hedge the exposure of variability in expected future cash flows predominantly attributable to forecasted purchases to supply fixed price sale contracts. These derivatives are recorded on the balance sheet at fair value as price risk management assets or liabilities. The effective portion of the gain or loss on these cash flow hedges is recorded in other comprehensive income in partner s capital and reclassified into earnings as a component of cost of product sold in the same period in which the hedged transaction affects earnings. Any ineffective portion of the gain or loss is recognized as cost of product sold in the current period. Accumulated other comprehensive loss was $10.7 million and $25.3 million at March 31, 2009 and September 30, 2008, respectively.

Inergy s policy is to offset fair value amounts of derivative instruments and cash collateral paid or received with the same counterparty under a master netting arrangement.

The cash flow impact of derivative financial instruments is reflected as cash flows from operating activities in the consolidated statements of cash flows.

**Revenue Recognition**

Sales of propane, other liquids and salt are recognized at the time product is shipped or delivered to the customer depending on the sales terms. Gas processing and fractionation fees are recognized upon delivery of the product. Revenue from the sale of propane appliances and equipment is recognized at the later of the time of sale or installation. Revenue from repairs and maintenance is recognized upon completion of the service. Revenue from storage contracts is recognized during the period in which storage services are provided.

**INERGY, L.P. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

***(unaudited)***

**Expense Classification**

Cost of product sold consists of tangible products sold including all propane and other natural gas liquids, salt and all propane related appliances. Operating and administrative expenses consist of all expenses incurred by Inergy other than those described above in cost of product sold and depreciation and amortization. Certain of Inergy s operating and administrative expenses and depreciation and amortization are incurred in the distribution of product and storage sales but are not included in cost of product sold. These amounts were $32.9 million and $33.1 million for the three months ended March 31, 2009 and 2008, respectively, and $66.0 million and $65.4 million for the six months ended March 31, 2009 and 2008, respectively.

**Use of Estimates**

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amount of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates.

**Inventories**

Inventories for retail operations, which mainly consist of propane gas and other liquids, are stated at the lower of cost or market and are computed using the average-cost method. Wholesale propane and other liquids inventories are designated under a fair value hedge program and are consequently marked to market. All wholesale propane and other liquids inventories being hedged and carried at market value at March 31, 2009 and September 30, 2008 amount to $15.5 million and $36.4 million, respectively. Inventories for midstream operations are stated at the lower of cost or market determined using the first-in-first-out method.

**Shipping and Handling Costs**

Shipping and handling costs are recorded as part of cost of product sold at the time product is shipped or delivered to the customer except as discussed in Expense Classification .

**Property, Plant and Equipment**

Property, plant and equipment are stated at cost. Depreciation is computed by the straight-line method over the estimated useful lives of the assets, as follows:

| | Years |
|---|---|
| Buildings and improvements | 25-40 |
| Office furniture and equipment | 3 10 |
| Vehicles | 5 10 |
| Tanks and plant equipment | 5 30 |

**Identifiable Intangible Assets**

The Company has recorded certain identifiable intangible assets, including customer accounts, covenants not to compete, trademarks, deferred financing costs and deferred acquisition costs. Customer accounts, covenants not to compete, and trademarks have arisen from the various acquisitions by Inergy. Deferred financing costs represent financing costs incurred in obtaining financing and are amortized over the term of the related debt. Deferred acquisition costs represent costs incurred on acquisitions that Inergy is actively pursuing. Additionally, an acquired intangible asset should be separately recognized if the benefit of the intangible asset is obtained through contractual or other legal rights, or if the

intangible asset can be sold, transferred, licensed, rented or exchanged, regardless of the acquirer s intent to do so.

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**INERGY, L.P. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

***(unaudited)***

Certain intangible assets are amortized on a straight-line basis over their estimated economic lives, as follows:

| | Years |
|---|---|
| Customer accounts | 15 |
| Covenants not to compete | 2  10 |
| Deferred financing costs | 1  10 |

Trademarks have been assigned an indefinite economic life and are not being amortized, but are subject to an annual impairment evaluation.

**Goodwill**

Goodwill is recognized pursuant to Statement of Financial Accounting Standards No. 142,  Goodwill and Other Intangible Assets,  ( SFAS 142 ) for various acquisitions by Inergy as the excess of the cost of the acquisitions over the fair value of the related net assets at the date of acquisition. Under SFAS 142, goodwill is subject to at least an annual assessment for impairment by applying a fair-value-based test.

In connection with the goodwill impairment evaluation, the Company identified four reporting units. The carrying value of each reporting unit is determined by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units as of the date of the evaluation on a specific identification basis. To the extent a reporting unit s carrying value exceeds its fair value, an indication exists that the reporting unit s goodwill may be impaired and the second step of the impairment test must be performed. In the second step, the implied fair value of the goodwill is determined by allocating the fair value to all of its assets (recognized and unrecognized) and liabilities in a manner similar to a purchase price allocation in accordance with Statement of Financial Accounting Standards No. 141,  Business Combinations,  ( SFAS 141 ) to its carrying amount.

Inergy completed its annual impairment test for each of its reporting units and determined that no impairment existed as of September 30, 2008. No indicators of impairment were identified requiring an interim impairment test during the six-month period ended March 31, 2009.

**Income Taxes**

Inergy is a publicly-traded master limited partnership. Partnerships are generally not subject to Federal income tax, although publicly-traded partnerships are treated as corporations for Federal income tax purposes and therefore are subject to federal income tax, unless the partnership generates at least 90% of its gross income from qualifying sources. If the qualifying income requirement is satisfied, the publicly-traded partnership will be treated as a partnership for Federal income tax purposes. Inergy Sales and Service, Inc. ( Services ), a subsidiary of Inergy, does not generate at least 90% of its gross income from qualifying sources, and as such, federal and state income taxes are provided on the taxable income of Services. The remaining Inergy subsidiaries generate at least 90% of gross income from qualifying sources. As a result, except for the operations of Services, Inergy s net earnings for Federal income tax purposes are allocated to the individual partners for inclusion in their income tax returns. Legislation in certain states allows for taxation of partnerships. As such, certain state taxes for Inergy have also been included in the accompanying financial statements as income taxes due to the nature of the tax in those particular states. Net earnings for financial statement purposes may differ significantly from taxable income reportable to unitholders as a result of differences between the tax basis and the financial reporting basis of assets and liabilities and the taxable income allocation requirements under the partnership agreement.

**Sales Tax**

Inergy accounts for the collection and remittance of sales tax on a net tax basis. As a result, these amounts are not reflected in the consolidated statements of operations.

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**INERGY, L.P. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

***(unaudited)***

**Income Per Unit**

The Company calculates basic net income per unit by dividing net income, after considering the Non-Managing General Partner s interest, including priority distributions, by the weighted average number of limited partner units outstanding. Under this method, the calculation of net income per unit reflects an allocation of earnings to each class of units that is consistent with the partnership agreement s treatment of the respective classes capital accounts. Diluted net income per limited partner unit is computed by dividing net income, after considering the Non-Managing General Partner s interest, by the sum of weighted average number of common units and the effect of other dilutive units.

**Accounting for Unit-Based Compensation**

Inergy has a unit-based employee compensation plan, which is accounted for under the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123(R), Share-Based Payment ( SFAS 123(R) ). SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values.

The amount of compensation expense recorded by the Company under the provisions of SFAS 123(R) during the six months ended March 31, 2009 and 2008 was approximately $1.4 million and $0.8 million, respectively. The compensation expense includes unit-based compensation expense for options and restricted shares on Inergy Holdings, L.P. units granted to the Company s employees.

**Segment Information**

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information ( SFAS 131 ) establishes standards for reporting information about operating segments, as well as related disclosures about products and services, geographic areas, and major customers. Further, SFAS 131 defines operating segments as components of an enterprise for which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and assessing performance. In determining reportable segments under the provisions of SFAS 131, Inergy examined the way it organizes its business internally for making operating decisions and assessing business performance. See Note 10 for disclosures related to Inergy s propane and midstream segments.

**Recently Issued Accounting Pronouncements**

SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ) was issued in February 2007 to permit entities to choose to measure many financial instruments and certain other items at fair value at specified election dates. A business entity is required to report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The Company adopted SFAS 159 on October 1, 2008. The adoption of SFAS 159 did not have an impact on the Company s financial statements.

SFAS No. 157, Fair Value Measurements ( SFAS 157 ) was issued in September 2006 to define fair value, establish a framework for measuring fair value according to generally accepted accounting principles, and expand disclosures about fair value measurements. The Company adopted SFAS 157 on October 1, 2008. The adoption of SFAS 157 required certain additional footnote disclosures (*Note 6*), however, it did not have a significant impact on any amounts comprising the Balance Sheet, Statement of Operations, Statement of Partners Capital, or the Statement of Cash Flows.

In April 2007, the FASB issued FASB Staff Position No. FIN 39-1, Amendment of FASB Interpretation No. 39 ( FSP 39-1 ). FSP 39-1 permits companies to offset fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting agreement. In addition, upon the adoption, companies are permitted to change their accounting policy to offset or not offset fair value amounts recognized for derivative instruments under master netting arrangements. The Company adopted FSP 39-1 on October 1, 2008 and elected to change its accounting policy for derivative instruments executed with

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the same counterparty under a master netting agreement. Inergy s policy is to offset fair value amounts of derivative instruments and cash collateral paid or received with the same counterparty under a master netting arrangement. This change in accounting policy has been presented retroactively. The adoption of FSP 39-1 had the following impact on the September 30, 2008 balance sheet (*in millions*):

| | Original Value | Adjustment | Adjusted Value |
|---|---|---|---|
| Assets from price risk management activities | $ 79.2 | $ (45.9) | $ 33.3 |
| Prepaid expenses and other current assets | 46.1 | (24.2) | 21.9 |
| Accrued expenses | 89.5 | (20.6) | 68.9 |
| Customer deposits | 96.5 | (8.8) | 87.7 |
| Liabilities from price risk management activities | 97.7 | (40.7) | 57.0 |

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 ( SFAS 161 ). SFAS 161 applies to all derivative instruments and related hedged items accounted for under SFAS 133. SFAS 161 requires entities to provide greater transparency about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity s financial position, results of operations, and cash flows. The Company adopted SFAS 161 on March 31, 2009. The adoption of SFAS 161 required certain additional disclosures (Note 5), however, it did not impact any amounts comprising the Balance Sheet, Statement of Operations, Statement of Partners Capital, or the Statement of Cash Flows.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations ( SFAS 141R ), which replaces FASB Statement No. 141. SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non-controlling interest in the acquiree and the goodwill acquired. The Statement also establishes disclosure requirements designed to enable users to evaluate the nature and financial effects of the business combination. SFAS 141R is required to be adopted by the Company for business combinations for which the acquisition date is on or after October 1, 2009.

In December 2007, the FASB issued SFAS No. 160, Non-controlling Interests in Consolidated Financial Statements an amendment of ARB No. 51 ( SFAS 160 ). SFAS 160 requires that accounting and reporting for minority interests will be recharacterized as non-controlling interests and classified as a component of equity. SFAS 160 also establishes reporting requirements that provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners. SFAS 160 applies to all entities that prepare consolidated financial statements, except not-for-profit organizations, but will affect only those entities that have an outstanding non-controlling interest in one or more subsidiaries or that deconsolidate a subsidiary. SFAS 160 is required to be adopted by the Company for the fiscal year ended September 30, 2010. The Company is evaluating the potential financial statement impact of SFAS 160 to its consolidated financial statements.

In March 2008, the FASB ratified EITF Issue No. 07-4, Application of the Two-Class Method under FASB Statement No. 128 to Master Limited Partnerships ( EITF 07-4 ). EITF 07-4 applies to Master Limited Partnerships ( MLP ) that are required to make incentive distributions when certain thresholds have been met regardless of whether the IDR is a separate limited partner ( LP ) interest or embedded in the general partner interest. EITF 07-4 addresses how the current period earnings of an MLP should be allocated to the general partner, LP s and, when applicable, IDR s. EITF 07-4 is required to be adopted by the Company for the fiscal year ended September 30, 2010. The Company is evaluating the potential financial statement impact of EITF 07-4 to its consolidated financial statements.

In June 2008, the FASB ratified FSP EITF Issue No. 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities ( FSP EITF 03-6-1 ). FSP EITF 03-6-1 applies to the calculation of earnings per share ( EPS ) under SFAS 128, Earnings Per Share for share-based payment awards with rights to dividends or dividend equivalents. FSP EITF 03-6-1 states that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend

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equivalents are participating securities and shall be included in the computation of EPS pursuant to the two-class method. FSP EITF 03-6-1 is required to be adopted by the Company for the fiscal year ended September 30, 2010. The Company is evaluating the potential financial statement impact of FSP EITF 03-6-1 to its consolidated financial statements.

**Note 3 Certain Balance Sheet Information**

Inventories consist of the following at March 31, 2009 and September 30, 2008, respectively (*in millions*):

| | March 31, 2009 | September 30, 2008 |
|---|---|---|
| Propane gas and other liquids | $ 39.4 | $ 83.9 |
| Appliances, parts and supplies | 15.8 | 15.3 |
| Salt finished goods | 0.6 | 0.7 |
| Total inventory | $ 55.8 | $ 99.9 |

Property, plant and equipment consists of the following at March 31, 2009 and September 30, 2008, respectively (*in millions*):

| | March 31, 2009 | September 30, 2008 |
|---|---|---|
| Tanks and plant equipment | $ 715.2 | $ 713.8 |
| Buildings and improvements | 297.9 | 265.6 |
| Vehicles | 105.5 | 104.5 |
| Construction in process | 227.9 | 166.5 |
| Office furniture and equipment | 25.6 | 24.6 |
| | 1,372.1 | 1,275.0 |
| Less: accumulated depreciation | 282.8 | 244.7 |
| Total property, plant and equipment, net | $ 1,089.3 | $ 1,030.3 |

Intangible assets consist of the following at March 31, 2009 and September 30, 2008, respectively (*in millions*):

| | March 31, 2009 | September 30, 2008 |
|---|---|---|
| Customer accounts | $ 269.4 | $ 266.7 |
| Covenants not to compete | 72.5 | 72.2 |
| Deferred financing and other costs | 33.8 | 28.5 |
| Trademarks | 26.3 | 26.3 |
| | 402.0 | 393.7 |
| Less: accumulated amortization | 117.6 | 105.5 |

| | | | | |
|---|---|---|---|---|
| Total intangible assets, net | $ | 284.4 | $ | 288.2 |

**Note 4 Business Acquisitions**

In October 2008, the Company acquired the assets of the Blu-Gas group of companies ( Blu-Gas ) headquartered in Denver, North Carolina. Blu-Gas delivers propane to approximately 9,300 customers. In conjunction with the acquisition, the Company issued 309,194 common units to Blu-Gas in a private placement as a portion of the purchase price.

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The purchase price allocation for this acquisition as well as the acquisition of US Salt, LLC in August 2008 have been prepared on a preliminary basis pending final asset valuation and asset rationalization, and changes are expected when additional information becomes available. Changes to reflect final asset valuation of prior fiscal year acquisitions have been included in the Company s consolidated financial statements but are not material.

US GAAP requires that for any material business combination or disposition of assets, pro-forma information must be disclosed.

The fiscal 2009 acquisition was not considered material.

The operating results for this acquisition are included in the consolidated results of operations from the date of acquisition through March 31, 2009.

**Note 5 Risk Management**

The Company is exposed to certain market risks related to its ongoing business operations. These risks include exposure to changing commodity prices as well as fluctuations in interest rates. The Company utilizes derivative instruments to manage its exposure to fluctuations in commodity prices, which is discussed more fully below. The Company also utilizes derivative instruments to manage its exposure to fluctuations in interest rates, which is discussed more fully in Note 7.

**Commodity Derivative Instruments and Price Risk Management**

*Risk Management Activities*

Inergy sells propane and other commodities to energy related businesses and may use a variety of financial and other instruments including forward contracts involving physical delivery of propane. Inergy will enter into offsetting positions to hedge against the exposure its customer contracts create. Inergy does not designate these instruments as hedging instruments in accordance with SFAS 133. These instruments are marked to market with the changes in the market value reflected in cost of product sold. Inergy attempts to balance its contractual portfolio in terms of notional amounts and timing of performance and delivery obligations. This balance in the contractual portfolio significantly reduces the volatility in cost of product sold related to these instruments. However, immaterial net unbalanced positions can exist or are established based on assessment of anticipated short-term needs or market conditions.

*Cash Flow Hedging Activity*

Inergy sells propane and heating oil to retail customers at fixed prices. Inergy will enter into derivative instruments to hedge a significant portion of its exposure to fluctuations in commodity prices as a result of selling the fixed price contracts. These instruments are identified and qualify to be treated as cash flow hedges in accordance with SFAS 133. This accounting treatment requires the effective portion of the gain or loss on the derivative to be reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings.

*Fair Value Hedging Activity*

Inergy will enter into derivative instruments to hedge its exposure to fluctuating commodity prices that results from maintaining its wholesale inventory. The instruments hedging wholesale inventory qualify to be treated as fair value hedges in accordance with SFAS 133. This accounting treatment requires the fair value changes in both the derivative instruments and the hedged inventory to be recorded in cost of product sold.

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A significant amount of inventory held in bulk storage facilities is hedged as it is not expected to be sold in the immediate future and is therefore exposed to fluctuations in commodity prices. Commodity inventory held at retail locations is not hedged as this inventory is expected to be sold in the immediate future and is therefore not exposed to fluctuations in commodity prices over an extended period of time.

**Commodity Price and Credit Risk**

*Notional Amounts and Terms*

The notional amounts and terms of the Company s derivative financial instruments include the following at March 31, 2009 and September 30, 2008 (*in millions*):

| | March 31, 2009 | | September 30, 2008 | |
|---|---|---|---|---|
| | Fixed Price Payor | Fixed Price Receiver | Fixed Price Payor | Fixed Price Receiver |
| Propane, crude and heating oil (*barrels*) | 5.8 | 5.4 | 8.9 | 7.5 |
| Natural gas (*MMBTU s*) | 0.5 | | 0.7 | |

Notional amounts reflect the volume of transactions, but do not represent the amounts exchanged by the parties to the financial instruments. Accordingly, notional amounts do not reflect the Company s monetary exposure to market or credit risks.

*Fair Value of Derivative Instruments*

The following tables detail the amount and location on the Company s Balance Sheet and Statement of Operations related to all of its commodity derivatives (*in millions*):

| | Amount of Gain (Loss) Recognized in Net Income from Derivatives March 31, 2009 | | Amount of Gain (Loss) Recognized in Net Income on Item Being Hedged March 31, 2009 | |
|---|---|---|---|---|
| | Three Months Ended | Six Months Ended | Three Months Ended | Six Months Ended |
| Derivatives in fair value hedging relationships: | | | | |
| Commodity [(a)] | $ (2.8) | $ 6.7 | $ 2.5 | $ (6.5) |
| Debt [(b)] | (0.6) | 5.8 | 0.6 | (5.8) |
| Total fair value of derivatives | $ (3.4) | $ 12.5 | $ 3.1 | $ (12.3) |

| | Amount of Gain (Loss) Recognized in OCI on Effective Portion of Derivatives | Amount of Gain (Loss) Reclassified from OCI to Net Income | Amount of Gain (Loss) Recognized in Net Income on Ineffective |
|---|---|---|---|

| | March 31, 2009 | | March 31, 2009 | | Portion of Derivatives & Amount Excluded from Testing March 31, 2009 | |
|---|---|---|---|---|---|---|
| | Three Months Ended | Six Months Ended | Three Months Ended | Six Months Ended | Three Months Ended | Six Months Ended |
| Derivatives in cash flow hedging relationships: | | | | | | |
| Commodity (c) | $ (1.6) | $ (8.2) | $ (54.9) | $ (22.8) | $ 0.1 | $ |