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HERITAGE PROPANE PARTNERS L P

Form 10-K/A

November 26, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K/A

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED AUGUST 31, 2002

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 1-11727

HERITAGE PROPANE PARTNERS, L.P.
(Exact name of registrant as specified in its charter)

DELAWARE 73-1493906
(State or other jurisdiction of (I.R.S. Employer Identification No.)
incorporation or organization)

8801 SOUTH YALE AVENUE, SUITE 310, TULSA, OKLAHOMA 74137
(Address of principal executive offices and zip code)

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

Securities registered pursuant to Section 12(b) of the Act:

| | |
|----------------|--|
| Title of class | Name of each exchange on which registered |
| Common Units | New York Stock Exchange |

Securities registered pursuant to section 12(g) of the Act: None

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 No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

The aggregate market value as of November 5, 2002, of the registrant's Common

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Units held by nonaffiliates of the registrant, based on the reported closing price of such units on the New York Stock Exchange on such date, was approximately \$252,749,678

At November 5, 2002, the registrant had units outstanding as follows:
Heritage Propane Partners, L.P. 15,816,347 Common Units

Documents Incorporated by Reference: None

EXPLANATORY NOTE

We are filing this Amendment on Form 10-K/A in connection with the filing of a Registration Statement on Form S-3 (File No. 333-107324). That Registration Statement incorporates our annual report on Form 10-K for the fiscal year ended August 31, 2002, originally filed on November 27, 2002 (the "Original Filing"). This Form 10-K/A amends and restates in its entirety our annual report on Form 10-K for the fiscal year ended August 31, 2002.

As described in Note 2 to the Consolidated Financial Statements, we have revised our previously reported Consolidated Statements of Operations for the years ended August 31, 2002 and 2001 and for the eight months ended August 31, 2000 and have made corresponding revisions to the Notes to Consolidated Financial Statements to make the presentations required by EITF 02-3. This information was previously shown in the Consolidated Statements of Operations on a gross basis in the separately presented line items of "Revenues-liquids marketing", "Revenues-other" and "Costs and expenses -- liquids marketing", and is now presented on a net basis in a single line item as "Liquids marketing, net". The revisions had no effect on previously reported Operating Income or Net Income (Loss). Additionally, we have retitled "EBITDA" as "EBITDA, as adjusted" and made clarifications regarding how we calculate EBITDA, as adjusted. These revisions did not change how we calculate EBITDA, as adjusted, and it is calculated in the same manner as we have historically presented such information.

This Amendment makes certain changes in the form of additional or supplemental disclosures as follows:

- Part I -- Item 3. Legal Proceedings, pages 10-11: We have revised to expand the description of the litigation filed by Heritage against SCANA Corporation, Cornerstone Ventures, L.P. and Suburban Propane, L.P.
- Part II -- Item 5. Market for the Registrant's Units and Related Unitholder Matters, pages 14-15: We have revised to include a description of the Incentive Distribution Rights and additional information about the issuance of Common Units to the Class B Subordinated Unitholders, the Class C Units, and to disclose the total amount of distributions by the Partnership for the fiscal year and the exemptions from registration under the Securities Act of 1933.
- Part II -- Item 6. Selected Historical Financial and Operating Data, pages 17-20: We have revised the tables titled "Heritage Propane Partners, L.P. (formerly Peoples Gas) and "Heritage Propane Partners, L.P. (Predecessor Heritage) to reflect the "Liquids marketing, net" and "EBITDA, as adjusted" presentations described above, and added tables reconciling EBITDA, as adjusted to net income and to cash flows from operations.
- Part II -- Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, pages 23-33: We

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have revised to provide additional or supplemental disclosures about results of operations, the terms of our credit agreements and our long-term debt and other contractual obligations, our adoption of EITF 02-3, the recording of the minority interests of all partially owned subsidiaries and Heritage's buying and selling of derivative financial instruments.

- Part III -- Item 10. Directors and Executive Officers of the Registrant, Item 11. Executive Compensation and Item 12, Security Ownership of Certain Beneficial Owners and Management, pages 41-45: We have revised to include additional information relating to the reimbursement of the General Partner's and its affiliates' expenses and to include information regarding the beneficial ownership of U.S. Propane, L.P. and U.S. Propane L.L.C.
- Part IV -- Item 15. Exhibits, Financial Statement Schedules, and Report on Form 8-K -- Notes to Consolidated Financial Statements, pages F-12-36: We have revised the notes to the consolidated financial statements to revise "Net revenues" and "Total Revenues" to reflect the "Liquids marketing, net" and EBITDA, as adjusted" presentations described above and to provide additional and supplemental information regarding (i) the recording of the minority interests of all partially owned subsidiaries, (ii) a description of our Costs and Expenses, (iii) clarifications with respect to the cost of fuel inventories and reclassifications into earnings of previously recorded gains and losses, (iv) when goodwill is tested for impairment, (v) Heritage's buying and selling of derivative financial instruments and liquids marketing contracts, (vi) our adoption of EITF 02-3, (vii) acquisitions, (viii) the Note Agreements and the Bank Credit Facility, (ix) our leases and accruals for legal proceedings and environmental liabilities, (x) the estimates of compensation under the Restricted Unit Plan and the Long-Term Incentive Plan, and (xi) the additional line item "Gross Profit." In addition, we have

i

added a note for subsequent developments describing the proposed transactions entered into on November 6, 2003.

This report continues to speak as of the date of the Original Filing, and we have not updated the disclosure in this report to speak as of a later date. All information contained in this report and the Original Filing is subject to updating and supplementing as provided in our periodic reports filed with the Securities and Exchange Commission.

ii

HERITAGE PROPANE PARTNERS, L.P.

2002 FORM 10-K ANNUAL REPORT

TABLE OF CONTENTS

PART I

Edgar Filing: HERITAGE PROPANE PARTNERS L P - Form 10-K/A

| | PAGE |
|--|------|
| | ---- |
| ITEM 1. BUSINESS. | 1 |
| ITEM 2. PROPERTIES..... | 9 |
| ITEM 3. LEGAL PROCEEDINGS..... | 10 |
| ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS..... | 11 |

PART II

| | |
|---|----|
| ITEM 5. MARKET FOR THE REGISTRANT'S UNITS AND RELATED UNITHOLDER MATTERS..... | 12 |
| ITEM 6. SELECTED HISTORICAL FINANCIAL AND OPERATING DATA..... | 16 |
| ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS..... | 21 |
| ITEM 7a. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK..... | 35 |
| ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA..... | 38 |
| ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE..... | 38 |

PART III

| | |
|---|----|
| ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT..... | 39 |
| ITEM 11. EXECUTIVE COMPENSATION..... | 43 |
| ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT..... | 46 |
| ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS..... | 48 |

PART IV

| | |
|---|----|
| ITEM 14. CONTROLS AND PROCEDURES..... | 49 |
| ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K..... | 49 |

iii

PART I

ITEM 1. BUSINESS

Heritage Propane Partners, L.P., (the "Registrant" or "Partnership"), a publicly traded Delaware limited partnership, was formed in April 1996 in connection with its initial public offering. The Partnership's Common Units are listed on the New York Stock Exchange. In order to simplify the Partnership's obligations under the laws of several jurisdictions in which it conducts business, its business activities are primarily conducted through its

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subsidiary, Heritage Operating, L.P. (the "Operating Partnership"), a Delaware limited partnership. The Partnership holds a 98.9899% limited partner interest in the Operating Partnership. The Operating Partnership accounts for nearly all of the consolidated assets, sales and operating earnings of the Partnership.

The sole General Partner of the Partnership and the Operating Partnership is U.S. Propane, L.P. ("U.S. Propane"), a Delaware limited partnership. U.S. Propane holds a 1% general partner interest in the Partnership and a 1.0101% general partner interest in the Operating Partnership. U.S. Propane is a joint venture among the following four publicly traded utilities: TECO Energy, Inc.; AGL Resources, Inc.; Piedmont Natural Gas Company, Inc.; and Atmos Energy Corporation.

- TECO Energy, Inc. ("TECO") is a diversified, energy-related holding company. TECO's subsidiaries include Florida's largest natural gas distributor, an electric utility, and an independent power company that builds, owns and operates electric generation facilities in the United States and Central America.
- AGL Resources, Inc. ("AGL Resources"), is a regional energy holding company engaged in natural gas distribution, wholesale and retail energy services, and building telecommunications infrastructure. AGL Resources' principal subsidiary is the second largest pure natural gas distributor in the United States, serving customers in Georgia, Tennessee, and Virginia.
- Piedmont Natural Gas Company, Inc. ("Piedmont Natural Gas") is an energy and services company primarily engaged in the transportation, distribution, and sales of natural gas. Piedmont Natural Gas is the second largest natural gas distributor in the Southeast, serving customers in North Carolina, South Carolina, and Tennessee.
- Atmos Energy Corporation ("Atmos Energy") is an energy and services company primarily engaged in natural gas distribution and nonregulated energy management and gas marketing services. Atmos Energy is the fifth largest pure natural gas distributor in the United States, serving customers in 11 states.

The business of the Partnership starting with the formation of Heritage Holdings, Inc. ("Heritage Holdings") in 1989, has grown primarily through acquisitions of retail propane operations and, to a lesser extent, through internal growth. Since its inception in 1989 through August 31, 2002, the Partnership has completed 91 acquisitions for a total purchase price of approximately \$633 million, including the August 2000 transfer by U.S. Propane of its propane operations to the Partnership. The U.S. Propane transaction combined five of the nation's 50 largest retail propane operations. Volumes of propane sold to retail customers have increased steadily from 63.2 million gallons for the Partnership's fiscal year ended August 31, 1992 to 329.6 million gallons for the fiscal year ended August 31, 2002.

U.S. PROPANE MERGER

In August 2000, TECO, AGL Resources, Piedmont Natural Gas, and Atmos Energy contributed each company's propane operations, Peoples Gas Company ("Peoples Gas"), United Cities Propane Gas, Inc. ("United Cities"), Piedmont Propane Company ("Piedmont"), and AGL Propane, Inc. ("AGL"), respectively, to U.S. Propane in exchange for equity interests in U.S. Propane. The merger was accounted for as an acquisition using the purchase method of accounting with Peoples Gas being the acquirer for accounting purposes.

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In August 2000, U.S. Propane acquired all of the outstanding common stock of the Partnership's former General Partner, Heritage Holdings, for \$120 million. By virtue of Heritage Holdings' general partner and limited partner interests in the Partnership, U.S. Propane gained control of the Partnership. Simultaneously with that

1

transaction, U.S. Propane transferred its propane operations, consisting of its interest in four separate limited liability companies, AGL Propane, L.L.C., Peoples Gas Company, L.L.C., United Cities Propane Gas, L.L.C. and Retail Propane Company, L.L.C. (former Piedmont operations) to the Partnership for \$181.4 million plus working capital. The \$181.4 million was payable \$139.5 million in cash, \$31.8 million of assumed debt, and the issuance of 372,392 Common Units of the Partnership valued at \$7.3 million and a 1.0101% limited partner interest in the Operating Partnership valued at \$2.7 million. The purchase price and the exchange price for the Common Units were approved by an independent committee of the Board of Directors of Heritage Holdings. The exchange price for the Common Units was \$19.73125 per unit under a formula based on the average closing price of Common Units on the New York Stock Exchange for the twenty (20) day period beginning ten (10) days prior to the public announcement of the transaction on June 15, 2000 (the "Formula Price"). Subsequent to August 31, 2000, payments totaling approximately \$12.9 million were made for the working capital adjustment, of which \$5.0 million was accrued at August 31, 2000.

Concurrent with the acquisition, the Operating Partnership borrowed \$180 million from several institutional investors and the Partnership sold 1,161,814 Common Units and 1,382,514 Class B Subordinated Units in a private placement to the former shareholders of Heritage Holdings. The price paid was based on the Formula Price and resulted in net proceeds to the Partnership of \$50.2 million. The total of these proceeds was utilized to finance the transaction and retire a portion of existing debt.

The Partnership is the surviving entity for legal purposes; however, the combined operations that formed U.S. Propane was the acquirer for accounting purposes. For purposes of the discussion herein, Peoples Gas is described as the accounting acquirer since Peoples Gas was the acquirer in the transaction that formed U.S. Propane. The propane operations of the Partnership and its subsidiaries prior to the series of transactions with U.S. Propane are referred to as Predecessor Heritage and the operations of the Partnership and its subsidiaries following the combination of the operations of U.S. Propane and Predecessor Heritage are described as Heritage. Peoples Gas had a fiscal year-end of December 31. The eight-month period ended August 31, 2000 was treated as a transition period under the rules of the Securities and Exchange Commission. However, the Form 10-K for the year ended August 31, 2000 was not a transition report as the Partnership continues to have an August 31 fiscal year-end.

On February 4, 2002, at the Special Meeting of the Common Unitholders of the Partnership, the Common Unitholders approved the substitution of U.S. Propane as the General Partner of the Partnership and the Operating Partnership, replacing the former General Partner, Heritage Holdings. U.S. Propane, L.L.C. ("USPLLC"), a Delaware limited liability company, is the General Partner of U.S. Propane. The membership interests of USPLLC are owned by AGL Energy Corporation, United Cities, TECO Propane Ventures, LLC, and Piedmont. The substitution of U.S. Propane as the General Partner did not alter the management of the Partnership, as all of the directors of Heritage Holdings became members of the Board of Managers of USPLLC, and the management and employees of Heritage Holdings became the management and employees of U.S. Propane.

GENERAL

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Heritage believes it is presently the fourth largest retail marketer of propane in the United States (as measured by retail gallons sold). Heritage currently serves more than 600,000 active residential, commercial, industrial and agricultural customers from over 275 customer service locations in 28 states. Heritage's operations extend from coast to coast with concentrations in the western, upper midwestern, northeastern, and southeastern regions of the United States.

At the time of the series of transactions that formed U.S. Propane and combined the operations of Predecessor Heritage and U.S. Propane, Peoples Gas was serving more than 70,000 active residential, commercial and wholesale customers located in the Florida peninsula. Peoples Gas had grown by expanding existing markets as well as through acquisitions of independent propane operations located in northeast and southwest Florida. Peoples Gas believed it was among the top 25 independent propane distributors nationally and the largest independent propane distributor in Florida.

Peoples Gas believed it held competitive advantages in both the residential and commercial markets through its focus on customer service and product reliability. Following is a summary of the retail sales volumes per fiscal year. The transition period ended August 31, 2000 represents seven months of Peoples Gas stand-alone and one

2

month of Heritage. The years ended August 31, 2001 and August 31, 2002 reflect the sales of the combined operations of Peoples Gas and Predecessor Heritage following the U.S. Propane merger.

HERITAGE PROPANE PARTNERS, L.P. (FORMERLY PEOPLES GAS):

| | For the Years Ended December 31, | | | For the Eight-months Ended August 31, | For the Years En August 31, | |
|---------------------------------------|-------------------------------------|------|------|---|--------------------------------|-------|
| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| RETAIL GALLONS SOLD (IN MILLIONS): | 29.1 | 30.9 | 33.6 | 38.3 | 330.2 | 329.9 |

As a result of the implementation of the strategy of Heritage described below, Predecessor Heritage achieved the following retail sales volumes per fiscal year:

PREDECESSOR HERITAGE:

| | For the Years Ended August 31, | | | | Period Ended Aug. 9, |
|---------------------------------------|--------------------------------|-------|-------|-------|----------------------------|
| | 1996 | 1997 | 1998 | 1999 | 2000 |
| RETAIL GALLONS SOLD (IN MILLIONS): | 118.2 | 125.6 | 146.7 | 159.9 | 170.9 |

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Management believes that Heritage's competitive strengths include: (i) experience in identifying, evaluating, and completing acquisitions, (ii) operations that are focused in areas experiencing higher-than-average population growth, (iii) a low-cost administrative infrastructure, and (iv) a decentralized operating structure and entrepreneurial workforce. These competitive strengths have enabled both Predecessor Heritage and Heritage to achieve performance levels per retail gallon sold that management believes are among the highest of any publicly traded propane partnership. Management believes that as a result of Heritage's geographic diversity and district-level incentive compensation program, Predecessor Heritage and Heritage have both been able to reduce the effect of adverse weather conditions on Heritage's operating results, including those experienced by Predecessor Heritage during the warmer-than-normal winters of 1998 - 1999, 1999 - 2000, and by Heritage in 2001 - 2002, recorded as three of the warmest winters of the century. Management believes that Heritage's concentration in higher-than-average population growth areas provides a strong economic foundation for expansion through acquisitions and internal growth. Management does not believe that Heritage is significantly more vulnerable than its competitors to displacement by natural gas distribution systems because the majority of Heritage's areas of operations are located in rural areas where natural gas is not readily available.

BUSINESS STRATEGY

Heritage's goal is to increase distributions to the Partnership's Unitholders by being a low-cost, growth oriented retail propane distribution company. The three critical elements to this strategy are described below.

Acquisitions. Acquisitions are the principal means of growth for Heritage, as the retail propane industry is mature and overall demand for propane is expected to experience limited growth in the foreseeable future. Management believes that the fragmented nature of the propane industry provides significant opportunities for growth through acquisition. Heritage follows a disciplined acquisition strategy that concentrates on companies that (i) are located in geographic areas experiencing higher-than-average population growth, (ii) provide a high percentage of sales to residential customers, (iii) have a strong reputation for quality service, and (iv) own a high percentage of the propane tanks used by their customers. In addition Heritage attempts to capitalize on the reputations of the companies it acquires by maintaining local brand names, billing practices, and employees, thereby creating a sense of continuity and minimizing customer loss. Management believes that this strategy has helped to make Heritage an attractive buyer for many acquisition candidates from the seller's viewpoint.

Through August 9, 2000, Predecessor Heritage had completed 68 acquisitions for a total purchase price of approximately \$297 million. Of the 68 companies acquired by Predecessor Heritage, 19 represented "core acquisitions" with multiple plants in a specific geographic area, with the balance representing "blend-in companies"

3

or acquisitions of companies that operated in an existing Heritage region. On August 10, 2000, Predecessor Heritage completed the merger with U.S. Propane. During the period between August 10, 2000 through August 31, 2002, Heritage completed 22 additional acquisitions. Heritage will focus on acquisition candidates in its existing areas of operations, but will consider core acquisitions in other higher-than-average population growth areas in order to further reduce the impact adverse weather patterns in any one region may have on Heritage's overall operations. While Heritage is currently evaluating numerous acquisition candidates, there can be no assurance that Heritage will identify

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attractive acquisition candidates in the future, that Heritage will be able to acquire such businesses on economically acceptable terms or successfully integrate them into existing operations and make cost-saving changes, that any acquisition will not dilute earnings and distributions to Unitholders, or that any additional debt incurred to finance an acquisition will not adversely affect the ability of Heritage to make distributions to Unitholders.

In order to facilitate Heritage's acquisition strategy, the Operating Partnership maintains a Bank Credit Facility with a total of \$115 million available for borrowing. The Bank Credit Facility consists of a \$50 million Acquisition Facility to be used for acquisitions and improvements and a \$65 million Working Capital Facility to be used for working capital and other general partnership purposes. Heritage also has the ability to fund acquisitions through the issuance of additional partnership interests and through long-term debt. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - Description of Indebtedness."

Low-Cost, Decentralized Operations. Heritage focuses on controlling costs at the corporate and district levels. While Predecessor Heritage realized certain economies of scale as a result of its acquisitions, it attributes its low operating costs primarily to its decentralized structure, which Heritage has continued. By delegating all customer billing and collection activities to the district level, Heritage has been able to operate without a large corporate staff. Of the 2,265 full-time employees as of August 31, 2002, only 86, or approximately 4%, were general and administrative. In addition, Heritage's district level incentive compensation program encourages district employees at all levels to control costs while increasing revenues.

Internal Growth. In addition to pursuing expansion through acquisitions, Heritage has aggressively focused on internal growth at its existing district locations. Heritage believes that, by concentrating its operations in areas experiencing higher-than-average population growth, it is well positioned to achieve internal growth by adding new customers. Heritage also believes that its decentralized operations foster an entrepreneurial corporate culture by: (i) having operational decisions made at the district and regional level, (ii) retaining billing, collection and pricing responsibilities at the local and regional levels, and (iii) rewarding employees for achieving financial targets at the local level.

WEATHER AND SEASONALITY

Heritage's propane distribution business is seasonal and dependent upon weather conditions in its service areas. Propane sales to residential and commercial customers are affected by winter heating season requirements. This generally results in higher operating revenues and net income during the period from October through March of each year and lower operating revenues and either net losses or lower net income during the period from April through September of each year. Sales to industrial and agricultural customers are much less weather sensitive.

Gross profit margins are not only affected by weather patterns but also by changes in customer mix. For example, sales to residential customers ordinarily generate higher margins than sales to other customer groups, such as commercial or agricultural customers. In addition, gross profit margins vary by geographic region. Accordingly, gross profit margins could vary significantly from year to year in a period of identical sales volumes.

INDUSTRY BACKGROUND AND COMPETITION

Propane, a by-product of natural gas processing and petroleum refining,

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is a clean-burning energy source recognized for its transportability and ease of use relative to alternative forms of stand-alone energy sources. Retail propane use falls into three broad categories: (i) residential applications, (ii) industrial, commercial, and agricultural applications, and (iii) other retail applications, including motor fuel sales. Residential customers use propane primarily for space and water heating. Industrial customers use propane primarily as fuel for forklifts, stationary engines, and furnaces, as a cutting gas, in mining operations, and in other process applications. Commercial customers, such as restaurants, motels, laundries, and commercial buildings, use propane in a variety of applications, including cooking, heating, and drying. In the agricultural market, propane is primarily used for tobacco curing, crop drying, poultry brooding, and weed control. Other retail uses include motor fuel for cars and trucks, outdoor cooking and other recreational uses, propane resales, and sales to state and local governments. In its wholesale operations, Heritage sells propane principally to large industrial end-users and other propane distributors.

Propane is extracted from natural gas or oil wellhead gas at processing plants or separated from crude oil during the refining process. Propane is normally transported and stored in a liquid state under moderate pressure or refrigeration for ease of handling in shipping and distribution. When the pressure is released or the temperature is increased, it is usable as a flammable gas. Propane is naturally colorless and odorless. An odorant is added to allow its detection. Like natural gas, propane is a clean burning fuel and is considered an environmentally preferred energy source.

Propane competes with other sources of energy, some of which are less costly for equivalent energy value. Heritage competes for customers against suppliers of electricity, natural gas, and fuel oil. Competition from alternative energy sources has been increasing as a result of reduced utility regulation. Except for certain industrial and commercial applications, propane is generally not competitive with natural gas in areas where natural gas pipelines already exist because natural gas is a significantly less expensive source of energy than propane. The gradual expansion of the nation's natural gas distribution systems has resulted in the availability of natural gas in many areas that previously depended upon propane. Although the extension of natural gas pipelines tends to displace propane distribution in areas affected, Heritage believes that new opportunities for propane sales arise as more geographically remote neighborhoods are developed. Even though propane is similar to fuel oil in certain applications and market demand, propane and fuel oil compete to a lesser extent primarily because of the cost of converting from one to another. Based upon information provided by the Energy Information Administration, propane accounts for approximately three percent of household energy consumption in the United States.

In addition to competing with alternative energy sources, Heritage competes with other companies engaged in the retail propane distribution business. Competition in the propane industry is highly fragmented and generally occurs on a local basis with other large multi-state propane marketers, thousands of smaller local independent marketers, and farm cooperatives. Most of Heritage's customer service locations compete with five or more marketers or distributors. Each retail distribution outlet operates in its own competitive environment because retail marketers tend to locate in close proximity to customers. The typical retail distribution outlet generally has an effective marketing radius of approximately 50 miles although in certain rural areas the marketing radius may be extended by satellite locations.

The ability to compete effectively further depends on the reliability of service, responsiveness to customers, and the ability to maintain competitive prices. Heritage believes that its safety programs, policies, and procedures are more comprehensive than many of its smaller, independent competitors and give it a competitive advantage over such retailers. Heritage also believes that its

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service capabilities and customer responsiveness differentiate it from many of these smaller competitors. Heritage's employees are on call 24-hours-a-day, 7-days-a-week for emergency repairs and deliveries.

The wholesale propane business is highly competitive. For fiscal year 2002, Heritage's domestic wholesale operations (excluding MP Energy Partnership) accounted for only 4.8% of its total gallons sold in the United States and less than 1% of its gross profit. Heritage does not emphasize wholesale operations, but it believes that limited wholesale activities enhance its ability to supply its retail operations.

5

PRODUCTS, SERVICES AND MARKETING

Heritage distributes propane through a nationwide retail distribution network consisting of over 275 customer service locations in 28 states. Heritage's operations are concentrated in large part in the western, upper midwestern, northeastern, and southeastern regions of the United States. Heritage serves more than 600,000 active customers. Historically, approximately two-thirds of Predecessor Heritage's and Heritage's retail propane volumes and in excess of 80% of their EBITDA, as adjusted were attributable to sales during the six-month peak-heating season from October through March, as many customers use propane for heating purposes. Consequently, sales and operating profits are normally concentrated in the first and second fiscal quarters. Cash flows from operations however, are generally greatest during the second and third fiscal quarters when customers pay for propane purchased during the six-month peak season. To the extent necessary, Heritage will reserve cash from peak periods for distribution to Unitholders during the warmer seasons.

Typically, district locations are found in suburban and rural areas where natural gas is not readily available. Generally, such locations consist of a one to two acre parcel of land, an office, a small warehouse and service facility, a dispenser, and one or more 18,000 to 30,000 gallon storage tanks. Propane is generally transported from refineries, pipeline terminals, leased storage facilities, and coastal terminals by rail or truck transports to Heritage's district locations where it is unloaded into storage tanks. In order to make a retail delivery of propane to a customer, a bobtail truck is loaded with propane from the storage tank. Propane is then delivered to the customer by the bobtail truck, which generally holds 2,500 to 3,000 gallons of propane, and pumped into a stationary storage tank on the customer's premises. The capacity of these customer tanks ranges from approximately 100 gallons to 1,200 gallons, with a typical tank capacity of 100 to 300 gallons in milder climates and from 500 to 1,000 gallons in colder climates. Heritage also delivers propane to retail customers in portable cylinders, which typically have a capacity of 5 to 35 gallons. When these cylinders are delivered to customers, empty cylinders are picked up for refilling at Heritage's distribution locations or are refilled on site. Heritage also delivers propane to certain other bulk end-users of propane in tractor-trailer transports, which typically have an average capacity of approximately 10,500 gallons. End-users receiving transport deliveries include industrial customers, large-scale heating accounts, mining operations, and large agricultural accounts.

Heritage encourages its customers whose propane needs are temperature sensitive to implement a regular delivery schedule. Many of Heritage's residential customers receive their propane supply pursuant to an automatic delivery system which eliminates the customer's need to make an affirmative purchase decision and allows for more efficient route scheduling. Heritage also sells, installs, and services equipment related to its propane distribution business, including heating and cooking appliances.

Heritage owns, through its subsidiaries, a 60% interest in MP Energy

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Partnership, a Canadian partnership that supplies Heritage with propane as described below under "Propane Supply and Storage." When it is referred to or information is given regarding domestic operations, amounts attributable to MP Energy Partnership are generally excluded unless otherwise indicated.

Propane use falls into three broad categories: (i) residential applications, (ii) industrial, commercial, and agricultural applications, and (iii) other retail applications, including motor fuel sales. Approximately 95% of the domestic gallons sold by Heritage in the fiscal year ended August 31, 2002 were to retail customers and 5% to wholesale customers. Of the retail gallons sold by Heritage, 58% were to residential customers, 27% were to industrial, commercial and agricultural customers, and 15% were to other retail users. Sales to residential customers in the fiscal year ended August 31, 2002 accounted for 55% of total domestic gallons sold but accounted for approximately 71% of Heritage's gross profit from propane sales. Residential sales have a greater profit margin and a more stable customer base than other markets served by Heritage. Industrial, commercial and agricultural sales accounted for 20% of Heritage's gross profit from propane sales for the fiscal year ended August 31, 2002, with all other retail users accounting for 8%. Additional volumes sold to wholesale customers contributed less than 1% of gross profit from propane sales. No single customer accounts for 10% or more of revenues.

The propane business is very seasonal with weather conditions significantly affecting demand for propane. Heritage believes that the geographic diversity of its operations helps to reduce its nationwide exposure to regional weather. Although overall demand for propane is affected by climate, changes in price, and other factors, Heritage believes its residential and commercial business to be relatively stable due to the following characteristics:

6

- residential and commercial demand for propane has been relatively unaffected by general economic conditions due to the largely non-discretionary nature of most propane purchases,
- loss of customers to competing energy sources has been low due to the lack of availability or the high cost of alternative fuels,
- the tendency of Heritage's customers to remain with Heritage due to the product being delivered pursuant to a regular delivery schedule and to Heritage's ownership of over 90% of the storage tanks utilized by its customers, which prevents fuel deliveries from competitors, and
- the historic ability of Heritage to more than offset customer losses through internal growth of its customer base in existing markets.

Since home heating usage is the most sensitive to temperature, residential customers account for the greatest usage variation due to weather. Variations in the weather in one or more regions in which Heritage operates can significantly affect the total volumes of propane sold by Heritage and the margins realized thereon and, consequently, Heritage's results of operations. Heritage believes that sales to the commercial and industrial markets, while affected by economic patterns, are not as sensitive to variations in weather conditions as sales to residential and agricultural markets.

PROPANE SUPPLY AND STORAGE

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Supplies of propane from Heritage's sources historically have been readily available. Heritage purchases from over 50 energy companies and natural gas processors at numerous supply points located in the United States and Canada. In the fiscal year ended August 31, 2002, Enterprise Products Operating L.P. ("Enterprise") and Dynegy Liquids Marketing and Trade ("Dynegy") provided approximately 19% and 16% of Heritage's total propane supply, respectively. In addition, M-P Oils, Ltd., Heritage's wholly owned subsidiary that owns a 60% interest in MP Energy Partnership, a Canadian partnership, procured 16% of Heritage's total propane supply during the fiscal year ended August 31, 2002 through MP Energy Partnership. MP Energy Partnership buys and sells propane for its own account and supplies propane to Heritage for its northern United States operations.

Heritage believes that if supplies from Enterprise and Dynegy were interrupted it would be able to secure adequate propane supplies from other sources without a material disruption of its operations. Aside from Enterprise, Dynegy, and the supply procured by M-P Oils, Ltd., no single supplier provided more than 10% of Heritage's total domestic propane supply during the fiscal year ended August 31, 2002. Heritage believes that its diversification of suppliers will enable it to purchase all of its supply needs at market prices without a material disruption of its operations if supplies are interrupted from any of its existing sources. Although no assurances can be given that supplies of propane will be readily available in the future, Heritage expects a sufficient supply to continue to be available. However, increased demand for propane in periods of severe cold weather, or otherwise, could cause future propane supply interruptions or significant volatility in the price of propane.

Heritage typically enters into one-year supply agreements. The percentage of contract purchases may vary from year to year. Supply contracts generally provide for pricing in accordance with posted prices at the time of delivery or the current prices established at major delivery or storage points, and some contracts include a pricing formula that typically is based on these market prices. Most of these agreements provide maximum and minimum seasonal purchase guidelines. Heritage receives its supply of propane predominately through railroad tank cars and common carrier transport.

Because Heritage's profitability is sensitive to changes in wholesale propane costs, it generally seeks to pass on increases in the cost of propane to customers. Heritage has generally been successful in maintaining retail gross margins on an annual basis despite changes in the wholesale cost of propane, but there is no assurance that Heritage will always be able to pass on product cost increases fully, particularly when product costs rise rapidly. Consequently, Heritage's profitability will be sensitive to changes in wholesale propane prices. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - General."

7

Heritage leases space in larger storage facilities in New York, Tennessee, Georgia, Michigan, Mississippi, South Carolina, Arizona, New Mexico, Texas, and smaller storage facilities in other locations and has the opportunity to use storage facilities in additional locations when it "pre-buys" product from sources having such facilities. Heritage believes that it has adequate third party storage to take advantage of supply purchasing advantages as they may occur from time to time. Access to storage facilities allows Heritage to buy and store large quantities of propane during periods of low demand, which generally occur during the summer months, or at favorable prices, thereby helping to ensure a more secure supply of propane during periods of intense demand or price instability.

PRICING POLICY

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Pricing policy is an essential element in the marketing of propane. Heritage relies on regional management to set prices based on prevailing market conditions and product cost, as well as local management input. All regional managers are advised regularly of any changes in the posted price of the district's propane suppliers. In most situations, Heritage believes that its pricing methods will permit Heritage to respond to changes in supply costs in a manner that protects Heritage's gross margins and customer base, to the extent such protection is possible. In some cases, however, Heritage's ability to respond quickly to cost increases could occasionally cause its retail prices to rise more rapidly than those of its competitors, possibly resulting in a loss of customers.

BILLING AND COLLECTION PROCEDURES

Customer billing and account collection responsibilities are retained at the district level. Heritage believes that this decentralized approach is beneficial for several reasons:

- the customer is billed on a timely basis;
- the customer is more apt to pay a "local" business;
- cash payments are received more quickly, and
- local personnel have a current account status available to them at all times to answer customer inquiries.

GOVERNMENT REGULATION

Heritage is subject to various federal, state, and local environmental, health and safety laws and regulations. Generally, these laws impose limitations on the discharge of pollutants and establish standards for the handling of solid and hazardous wastes. These laws include without limitation, the Resource Conservation and Recovery Act, the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), the Clean Air Act, the Occupational Safety and Health Act, the Emergency Planning and Community Right-to-Know Act, the Clean Water Act, and comparable state statutes. CERCLA, also known as the "Superfund" law, imposes joint and several liability in most instances, without regard to fault or the legality of the original conduct, on certain classes of persons that are considered to have contributed to the release or threatened release of a "hazardous substance" into the environment. Propane is not a hazardous substance within the meaning of CERCLA. However, certain automotive waste products generated by Heritage's truck fleet, as well as "hazardous substances" or "hazardous waste" disposed of during past operations by third parties on Heritage's properties, could subject Heritage to liability under CERCLA. Such laws and regulations could result in civil or criminal penalties in cases of non-compliance and impose liability for remediation costs. In addition, third parties may make claims against owners or operators of properties for personal injuries and property damage associated with releases of hazardous or toxic substances or waste.

In connection with all acquisitions of retail propane businesses that involve the acquisition of any interests in real estate, Heritage conducts an environmental review in an attempt to determine whether any substance other than propane has been sold from, or stored on, any such real estate prior to its purchase. Such review includes

questioning the seller, obtaining representations and warranties concerning the seller's compliance with environmental laws, and conducting inspections of the properties. Where warranted, independent environmental consulting firms are

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hired to look for evidence of hazardous substances or the existence of underground storage tanks.

Petroleum-based contamination or environmental wastes are known to be located on or adjacent to six sites, which Heritage presently has or which Heritage or its predecessors formerly had operations. These sites were evaluated at the time of their acquisition. In all cases, remediation operations have been or will be undertaken by others, and in all six cases, Heritage obtained indemnification for expenses associated with any remediation from the former owners or related entities. Based on information currently available to Heritage, such projects are not expected to have a material adverse effect on Heritage's financial condition or results of operations.

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

National Fire Protection Association Pamphlets No. 54 and No. 58, which establish rules and procedures governing the safe handling of propane, or comparable regulations, have been adopted as the industry standard in all of the states in which Heritage operates. In some states these laws are administered by state agencies, and in others they are administered on a municipal level. With respect to the transportation of propane by truck, Heritage is subject to regulations promulgated under the Federal Motor Carrier Safety Act. These regulations cover the transportation of hazardous materials and are administered by the United States Department of Transportation. Heritage conducts ongoing training programs to help ensure that its operations are in compliance with applicable regulations. Heritage maintains various permits that are necessary to operate its facilities, some of which may be material to its operations. Heritage believes that the procedures currently in effect at all of its facilities for the handling, storage, and distribution of propane are consistent with industry standards and are in compliance in all material respects with applicable laws and regulations.

Heritage has implemented environmental programs and policies designed to avoid potential liability and cost under applicable environmental laws. It is possible, however, that Heritage will have increased costs due to stricter pollution control requirements or liabilities resulting from non-compliance with operating or other regulatory permits. It is not anticipated that Heritage's compliance with or liabilities under environmental, health and safety laws and regulations, including CERCLA, will have a material adverse effect on Heritage. To the extent that there are any environmental liabilities unknown to Heritage or environmental, health and safety laws or regulations are made more stringent, there can be no assurance that Heritage's results of operations will not be materially and adversely affected.

EMPLOYEES

As of August 31, 2002, Heritage had 2,265 full time employees who were employed by the General Partner or subsidiaries of the Partnership, of whom 86 were general and administrative and 2,179 were operational employees. Of its operational employees, 67 are represented by labor unions. The General Partner

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believes that its relations with its employees are satisfactory. Historically, the General Partner has also hired seasonal workers to meet peak winter demands.

ITEM 2. PROPERTIES

Heritage operates bulk storage facilities at over 275 customer service locations. Heritage owns substantially all of these facilities and has entered into long-term leases for those that it does not own. Heritage believes that the increasing difficulty associated with obtaining permits for new propane distribution locations makes its high level of site ownership and control a competitive advantage. Heritage owns approximately 31 million gallons of above

9

ground storage capacity at its various plant sites and has leased an aggregate of approximately 50 million gallons of underground storage facilities in New York, Tennessee, Georgia, Michigan, Mississippi, South Carolina, Arizona, New Mexico, and Texas. Heritage does not own or operate any underground storage facilities (excluding customer and local distribution tanks) or pipeline transportation assets (excluding local delivery systems).

Heritage also owns a 50% interest in Bi-State Propane, a California general partnership that conducts business in California and Nevada. Bi-State Propane operates twelve customer service locations that are included on a gross basis in Heritage's site, customer, and other property descriptions contained herein. However, the financial statements of Bi-State Propane are audited separately and Heritage's 50% interest is accounted for under the equity method.

The transportation of propane requires specialized equipment. The trucks and railroad tank cars used for this purpose carry specialized steel tanks that maintain the propane in a liquefied state. As of August 31, 2002, Heritage utilized approximately 50 transport truck tractors, 50 transport trailers, 25 railroad tank cars, 1,050 bobtails and 1,567 other delivery and service vehicles, all of which Heritage owns. As of August 31, 2002, Heritage owned approximately 627,000 customer storage tanks with typical capacities of 120 to 1,000 gallons that are leased or available for lease to customers. These customer storage tanks are pledged as collateral to secure Heritage's obligations to its Banks and the holders of its Notes.

Heritage believes that it has satisfactory title to or valid rights to use all of its material properties. Although some of such properties are subject to liabilities and leases, liens for taxes not yet due and payable, encumbrances securing payment obligations under non-competition agreements, and immaterial encumbrances, easements, and restrictions, Heritage does not believe that any such burdens will materially interfere with the continued use of such properties by Heritage in its business, taken as a whole. In addition, Heritage believes that it has, or is in the process of obtaining, all required material approvals, authorizations, orders, licenses, permits, franchises, and consents of, and has obtained or made all required material registrations, qualifications and filings with, the various state and local government and regulatory authorities which relate to ownership of Heritage's properties or the operations of its business.

Heritage utilizes a variety of trademarks and tradenames that it owns or has secured the right to use, including "Heritage Propane." These trademarks and tradenames have been registered or are pending registration before the United States Patent and Trademark Office or the various jurisdictions in which the marks or tradenames are used. Heritage believes that its strategy of retaining the names of the companies it has acquired has maintained the local identification of these companies and has been important to the continued success of these businesses. Some of Heritage's most significant trade names include AGL Propane, Balgas, Bi-State Propane, Blue Flame Gas of Charleston, Blue Flame Gas of Mt. Pleasant, Blue Flame Gas, Carolane Propane Gas, Gas

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Service Company, EnergyNorth Propane, Gibson Propane, Guilford Gas, Holton's L. P. Gas, Ikard & Newsom, Northern Energy, Sawyer Gas, Peoples Gas Company, Piedmont Propane Company, ProFlame, Rural Bottled Gas and Appliance, ServiGas, and TECO Propane. Heritage regards its trademarks, tradenames, and other proprietary rights as valuable assets and believes that they have significant value in the marketing of its products.

ITEM 3. LEGAL PROCEEDINGS.

Propane is a flammable, combustible gas. Serious personal injury and significant property damage can arise in connection with its storage, transportation or use. In the ordinary course of business, Heritage is sometimes threatened with or is named as a defendant in various lawsuits seeking actual and punitive damages for product liability, personal injury, and property damage. Heritage maintains liability insurance with insurers in amounts and with coverages and deductibles it believes are reasonable and prudent, and which are generally accepted in the industry. However, there can be no assurance that the levels of insurance protection currently in effect will continue to be available at reasonable prices or that such levels will remain adequate to protect Heritage from material expenses related to product liability, personal injury or property damage in the future. Of the pending or threatened matters in which Heritage is a party, none have arisen outside the ordinary course of business except for an action filed by Heritage on November 30, 1999, is currently pending in the Court of Common Pleas, State of South Carolina, Richland County, against SCANA Corporation, Cornerstone Ventures, L.P. and Suburban Propane, L.P. (the "SCANA litigation"). Heritage has asserted under a number of contract and fraud causes of action that SCANA materially breached its contract with Heritage to sell its assets to Heritage, and is seeking an unspecified amount of

10

compensatory and punitive damages. The defendants have denied the claims and discovery is ongoing. Although any litigation is inherently uncertain, based on past experience, the information currently available and the availability of insurance coverage, Heritage does not believe that pending or threatened litigation matters will have a material adverse effect on its financial condition or results of operations.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matters were submitted to a vote of the security holders of the Partnership during the fourth quarter of the fiscal year ended August 31, 2002.

11

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S UNITS AND RELATED UNITHOLDER MATTERS.

MARKET PRICE OF AND DISTRIBUTIONS ON THE COMMON UNITS AND RELATED UNITHOLDER MATTERS

The Partnership's common units representing limited partners interests in the Partnership ("Common Units") are listed on the New York Stock Exchange under the symbol "HPG". The following table sets forth, for the periods indicated, the high and low sales prices per Common Unit, as reported on the New York Stock Exchange Composite Tape, and the amount of cash distributions paid per Common Unit.

Price Range

Cash

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| | High ----- | Low ----- | Distribution (1) ----- |
|--|---------------|--------------|---------------------------|
| 2002 FISCAL YEAR | | | |
| Fourth Quarter Ended August 31, 2002 | \$27.600 | \$22.500 | \$0.6375 |
| Third Quarter Ended May 31, 2002 | \$29.000 | \$26.500 | \$0.6375 |
| Second Quarter Ended February 28, 2002 | \$30.550 | \$25.510 | \$0.6375 |
| First Quarter Ended November 30, 2001 | \$28.990 | \$24.650 | \$0.6375 |
| 2001 FISCAL YEAR | | | |
| Fourth Quarter Ended August 31, 2001 | \$31.000 | \$25.250 | \$0.6250 |
| Third Quarter Ended May 31, 2001 | \$31.000 | \$23.950 | \$0.6125 |
| Second Quarter Ended February 28, 2001 | \$24.900 | \$20.125 | \$0.6000 |
| First Quarter Ended November 30, 2000 | \$23.875 | \$20.500 | \$0.5875 |

- (1) Distributions are shown in the quarter with respect to which they were declared. For each of the indicated quarters for which distributions have been made, an identical per unit cash distribution was paid on any Subordinated Units outstanding at such time.

DESCRIPTION OF UNITS

As of October 25, 2002, there were approximately 14,800 individual Common Unitholders, which includes Common Units held in street name. Common Units and Class C Units represent limited partner interests in the Partnership that entitle the holders to the rights and privileges specified in the Heritage Propane Partners, L.P. Partnership Agreement (the "Partnership Agreement"). As of November 5, 2002, there were 15,816,347 Common Units representing, an aggregate 98.9899% limited partner interest in the Partnership. Except as described below, the Common Units generally participate pro rata in Heritage's income, gains, losses, deductions, credits, and distributions. There are also 1,000,000 Class C Units outstanding that are entitled only to participate in distributions that Heritage may make that are attributable to amounts received by Heritage in connection with the SCANA litigation.

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

Common Units. The Partnership's Common Units are registered under the Securities Exchange Act of 1934 and are listed for trading on the New York Stock Exchange. Each holder of a Common Unit is entitled to one vote per unit on all matters presented to the Limited Partners for a vote. However, if at any time any person or group (other than the General Partner and its affiliates) owns beneficially 20% or more of all Common Units, any Common Units owned by that person or group may not be voted on any matter and are not considered to be outstanding when sending notices of a meeting of Unitholders (unless otherwise required by law), calculating required votes, determining the presence of a quorum or for other similar purposes under our Partnership Agreement. The Common Units are entitled to distributions of Available Cash as described below under "Cash Distribution Policy." As of

12

October 25, 2002, there were approximately 14,800 individual Common Unitholders, which includes Common Units held in street name.

Class C Units. In conjunction with the transaction with U.S. Propane and the change of control of the former General Partner, Heritage Holdings, the Partnership issued 1,000,000 newly created Class C Units to Heritage Holdings in

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conversion of that portion of its Incentive Distribution Rights that entitled it to receive any distribution made by the Partnership attributable to the net amount received by the Partnership in connection with the settlement, judgment, award or other final nonappealable resolution of the SCANA litigation filed by Heritage prior to the transaction with U.S. Propane. The Class C Units have zero initial capital account balance and were distributed by Heritage Holdings to its former stockholders in connection with the transaction with U.S. Propane. Thus, U.S. Propane will not receive any distributions made with respect to the SCANA litigation that would have gone to Heritage Holdings to the extent of its General Partner interest and Incentive Distribution Rights had it remained the General Partner of the Partnership.

All decisions of the General Partner relating to the SCANA litigation will be determined by a special litigation committee consisting of one or more independent directors of the General Partner. As soon as practicable after the time, if any, that the Partnership receives the final cash payment as a result of the resolution of the SCANA litigation, the special litigation committee will determine the aggregate net amount of such proceeds distributable by the Partnership by deducting from the amounts received all costs and expenses incurred by the Partnership and its affiliates in connection with the SCANA litigation and such cash reserves as the special committee deems necessary or appropriate. Until the special litigation committee decides to distribute the distributable proceeds, none of the distributable proceeds will be deemed to be "Available Cash" under the Partnership Agreement. Please read "Cash Distribution Policy" below for a discussion of Available Cash. When the special litigation committee decides to distribute the distributable proceeds, the amount of the distribution will be distributed in the same manner as the Partnership's distribution of Available Cash, as described below under "Cash Distribution Policy," except that the amount of distributable proceeds that would normally be distributed to holders of Incentive Distribution Rights will instead be distributed to the holders of the Class C Units, pro rata. The Partnership cannot predict whether it will receive any cash payments as a result of the SCANA litigation and, if so, when such distributions might be received.

Each holder of Class C Units receiving a distribution of cash in any taxable year of the Partnership will be allocated items of gross income with respect to such taxable year in an amount equal to the cash distributed to the holder. The holders of Class C Units will not be allocated any other items of income, gain, loss deduction or credit. The Class C Units do not have any rights to share in any of the assets or distributions upon dissolution and liquidation of the Partnership, except to the extent that any such distributions consist of proceeds from the SCANA litigation to which the Class C Unitholders would have otherwise been entitled. The Class C Units may not be converted into any other unit. The Class C Units have no voting rights except to the extent provided by Delaware law with respect to a vote as a class, in which case each Class C Unit will be entitled to one vote.

Class B Subordinated Units. Prior to February 4, 2002, the Partnership had Class B Subordinated Units representing limited partner interests that were issued to certain former stockholders of Heritage Holdings, who are or were also members of management, in connection with the transaction with U.S. Propane. The Class B Subordinated Units had the same voting rights as the Subordinated Units outstanding before the end of the Subordination Period, and generally participated pro rata with the Common Units in Heritage's income, gains, losses, deductions, credits, and distributions. Each Class B Subordinated Unitholder was entitled to one vote on each matter with respect to which the Class B Subordinated Units were entitled to vote.

On February 4, 2002, at the Special Meeting of the Common Unitholders of the Partnership, the Common Unitholders approved an amendment of the Partnership Agreement that converted all of the 1,382,514 outstanding Class B Subordinated Units into 1,382,514 Common Units. The Common Units issued upon

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conversion of the Class B Subordinated Units share equally with other Common Units in distributions of Available Cash.

Subordinated Units. At the time of the Partnership's initial public offering, the former General Partner, Heritage Holdings, held all of the Partnership's Subordinated Units. The Subordinated Units were a separate class of limited partner interests and the rights of holders of Subordinated Units to participate in distributions to partners differed from, and were subordinated to, the rights of the holders of Common Units.

13

Pursuant to the provisions of the Partnership Agreement relating to requirements that the Partnership meet specified cash performance and distribution requirements during successive four-quarter periods commencing with the initial public offering in June of 1996, all of the Subordinated Units converted into Common Units and the Subordination Period ended. Pursuant to the conversion provisions, 925,736 Subordinated Units converted into Common Units as of July 7, 1999, and 925,736 Subordinated Units converted into Common Units as of July 5, 2000. The remaining 1,851,471 Subordinated Units converted into Common Units as of July 6, 2001. Common Units issued upon conversion of the Subordinated Units share equally with other Common Units in distributions of Available Cash.

Incentive Distribution Rights. Incentive distribution rights represent the contractual right to receive an increasing percentage of quarterly distributions of available cash from operating surplus after the minimum quarterly distribution has been paid. Please read " -- Cash Distribution Policy" below. The General Partner owns all of the incentive distribution rights, except that in conjunction with the August 2000 transaction with U.S. Propane, the Partnership issued 1,000,000 Class C Units to Heritage Holdings, its general partner at that time, in conversion of that portion of Heritage Holdings' incentive distribution rights that entitled it to receive any distribution made by the Partnership of funds attributable to the net amount received in connection with the settlement, judgment, award or other final nonappealable resolution of the litigation filed by Heritage against SCANA Corporation, Cornerstone Ventures, L.P. and Suburban Propane, L.P. Any amount payable on the Class C Units in the future will reduce the amount otherwise distributable to holders of incentive distribution rights at the time the distribution of such litigation proceeds is made and will not reduce the amount distributable to holders of common units. No payments to date have been made on the Class C Units.

CASH DISTRIBUTION POLICY

The Partnership Agreement requires that the Partnership will distribute all of its Available Cash to its Unitholders and its General Partner within 45 days following the end of each fiscal quarter. The term Available Cash generally means, with respect to any fiscal quarter of the Partnership, all cash on hand at the end of such quarter, plus working capital borrowings after the end of the quarter, less reserves established by the General Partner in its sole discretion to provide for the proper conduct of the Partnership's business, comply with applicable law or any Heritage debt instrument or other agreement, or to provide funds for future distributions to partners with respect to any one or more of the next four quarters. Available Cash is more fully defined in the Partnership Agreement previously filed as an exhibit.

After the conversion of the Class B Subordinated Units was approved on February 4, 2002, each Class B Subordinated Unit converted into one Common Unit and participates pro rata with the other Common Units in distributions of Available Cash. Heritage currently distributes Available Cash, excluding any Available Cash to be distributed to the Class C Unitholders as follows:

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- First, 98% to all Unitholders, pro rata, and 2% to the General Partner, until all Unitholders have received \$0.50 per unit for such quarter and any prior quarter;
- Second, 98% to all Unitholders, pro rata, and 2% to the General Partner, until all Unitholders have received \$0.55 per unit for such quarter;
- Third, 85% to all Unitholders, pro rata, 13% to the holders of Incentive Distribution Rights, pro rata, and 2% to the General Partner, until all Common Unitholders have received at least \$0.635 per unit for such quarter;
- Fourth, 75% to all Unitholders, pro rata, 23% to the holders of Incentive Distribution Rights, pro rata and 2% to the General Partner, until all Common Unitholders have received at least \$0.825 per unit for such quarter; and
- Fifth, thereafter 50% to all Unitholders, pro rata, 48% to the holders of Incentive Distribution Rights, pro rata, and 2% to the General Partner

14

- The total amount of distributions for the 2002 fiscal year on Common Units and other outstanding limited partner interests, the general partner interests and the Incentive Distribution Rights totaled \$40.3 million, \$0.8 million and \$0.9 million, respectively. All such distributions were made from Available Cash from Operating Surplus.

CHANGES IN SECURITIES AND RECENT SALES OF UNREGISTERED SECURITIES

During the Partnership's fiscal year 2002, the following issuances of Common Units were made, all of which relied on one or more exemptions from registration under the Securities Act of 1933. On February 4, 2002, in conjunction with proposals approved by the Common Unitholders at the Special Meeting of the Common Unitholders of the Partnership and to facilitate the U.S. Propane transaction, 1,382,514 Common Units were issued to the Class B Subordinated Unitholders, who are or were members of management, upon the conversion and cancellation of the 1,382,514 previously outstanding Class B Subordinated Units.

In conjunction with the Common Unitholder approval of the substitution of U.S. Propane as the General Partner of the Partnership, the Partnership also issued 162,913 Common Units to the former General Partner, Heritage Holdings, in exchange for its 1.0101% general partner interest in the Operating Partnership, issued 158,026 Common Units to Heritage Holdings in conversion of its 1% general partner interest in the Partnership, and cancelled 158,026 Common Units previously held by U.S. Propane.

A total of 11,750 Common Units were issued by the Partnership to a former officer and to a former director of Heritage that had previously been awarded under the terms of the Partnership's Restricted Unit Plan.

All of the foregoing Units were not registered with the Securities and Exchange Commission under the Securities Act of 1933 by virtue of an exemption under Section 4(2) thereof.

EQUITY COMPENSATION PLAN INFORMATION

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At the time of its initial public offering, the Board of Directors of the Partnership's General Partner adopted a Restricted Unit Plan, amended and restated as of February 4, 2002 as the Partnership's Second Amended and Restated Restricted Unit Plan (the "Restricted Unit Plan"), which provided for the awarding of Common Units to key employees. See "Executive Compensation -- Restricted Unit Plan" for a description of the Restricted Unit Plan.

In conjunction with the U.S. Propane merger, the Partnership adopted a long term incentive plan (the "Long Term Incentive Plan"), which provides for awarding Common Units to the executive officers of the General Partner of the Partnership and certain other persons that may be designated by the Board of Directors. The Long Term Incentive Plan provides for a maximum award of 500,000 Common Units provided that certain targeted levels of cash distributions are reached. See "Executive Compensation -- Long Term Incentive Plan" for a description of the Long Term Incentive Plan.

The following table sets forth in tabular format, a summary of the Partnership's equity plan information:

15

| Plan Category ----- | Number of securities to be issued upon exercise of outstanding options, warrants and rights (a) | Weighted-average exercise price of outstanding options, warrants and rights (b) | Num remai futu equity (exc refle |
|---|---|---|---|
| Equity compensation plans approved by security holders | 39,400 | (1) \$1,087,440 | |
| Equity compensation plans not approved by security holders | - | - | |
| | ----- | ----- | |
| Total (2) | 39,400 ===== | \$1,087,440 ===== | |

(1) Valued as of October 31, 2002. Actual exercise price may differ depending on the Common Unit price on the date such units vest.

(2) As of October 31, 2002.

ITEM 6. SELECTED HISTORICAL FINANCIAL AND OPERATING DATA

HERITAGE

The following table sets forth, for the periods and as of the dates indicated, selected historical financial and operating data for Heritage Propane Partners, L.P. and its subsidiaries (formerly Peoples Gas and the surviving legal entity in the series of transactions with U.S. Propane). The selected historical financial and operating data should be read in conjunction with the financial statements of Heritage Propane Partners, L.P. (formerly Peoples Gas Company) included elsewhere in this report and "Management's Discussion and Analysis of Financial Condition and Results of Operations" also included elsewhere in this report. The amounts in the table below, except per unit data, are in thousands.

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HERITAGE PROPANE PARTNERS, L.P. (FORMERLY PEOPLES GAS):

| | Years ended December 31, | | | Eight Months Ended August 31, | |
|---|--------------------------|-----------|-----------|----------------------------------|---------|
| | 1997 | 1998 | 1999 | 1999 | 2000 |
| | ----- | ----- | ----- | ----- | ----- |
| | (Unaudited) | | | | |
| Statements of Operating Data: | | | | | |
| Revenues | \$ 32,874 | \$ 30,187 | \$ 34,045 | \$ 21,766 | \$ 51,5 |
| Gross profit (a) | 15,811 | 17,904 | 19,196 | 13,299 | 21,5 |
| Depreciation and amortization | 2,514 | 2,855 | 3,088 | 2,037 | 4,6 |
| Operating income (loss) | 1,370 | 3,961 | 2,885 | 2,666 | (7 |
| Interest expense | - | - | - | - | 2,4 |
| Income (loss) before income taxes and minority interests | 980 | 3,483 | 2,895 | 2,677 | (3,5 |
| Provision for income taxes | 378 | 1,412 | 1,127 | 1,035 | 3 |
| Net income (loss) | 602 | 2,071 | 1,768 | 1,642 | (3,8 |
| Net income (loss) per unit (b) | 0.35 | 1.19 | 1.02 | 0.94 | (0. |
| Cash dividends/distributions per unit | - | 1.13 | 1.30 | 1.30 | 0. |

16

| | As of December 31, | | | As o | |
|--|--------------------|----------|----------|-------------|-----------|
| | 1997 | 1998 | 1999 | 1999 | 2000 |
| | ----- | ----- | ----- | ----- | ----- |
| | (Unaudited) | | | (Unaudited) | |
| Balance Sheet Data | | | | | |
| Current assets | \$ 5,278 | \$ 4,310 | \$ 6,643 | \$ 4,326 | \$ 84,869 |
| Total assets | 33,982 | 37,206 | 43,724 | 39,481 | 615,779 |
| Current liabilities | 8,204 | 13,671 | 19,636 | 15,716 | 102,212 |
| Long-term debt | - | - | - | - | 361,990 |
| Minority interests | - | - | - | - | 4,821 |
| Partner's capital - general partner (b) | 39 | 39 | 37 | 37 | 939 |
| Partners' capital - limited partners (b) | 15,457 | 15,557 | 15,070 | 14,944 | 145,817 |

| | Years ended December 31, | | | Eight Months Ended August 31, | |
|---|--------------------------|----------|----------|----------------------------------|-----------|
| | 1997 | 1998 | 1999 | 1999 | 2000 |
| | ----- | ----- | ----- | ----- | ----- |
| Operating Data (unaudited): | | | | | |
| EBITDA, as adjusted (c) | \$ 3,884 | \$ 6,816 | \$ 5,973 | \$ 4,703 | \$ 4,507 |
| Cash flows from operating activities | 7,682 | 9,219 | 9,353 | - | 14,508 |
| Cash flows from investing activities | (4,497) | (7,047) | (7,191) | - | (183,037) |
| Cash flows from financing activities | (3,561) | (2,317) | (2,257) | - | 173,353 |
| Capital expenditures (d) | | | | | |

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| | | | | | |
|------------------------|--------|--------|--------|--------|---------|
| Maintenance and growth | 4,497 | 5,328 | 6,176 | 2,544 | 3,559 |
| Acquisition | - | 1,719 | 1,015 | 1,015 | 177,067 |
| Retail gallons sold | 29,077 | 30,921 | 33,608 | 22,118 | 38,268 |

- (a) Gross profit is computed by reducing total revenues by the direct cost of the products sold.
- (b) Net income (loss) per unit is computed by dividing the limited partner's interest in net income (loss) by the weighted average number of units outstanding. Although equity accounts of Peoples Gas survive the merger, Predecessor Heritage's partnership structure and partnership units survive. Accordingly, the equity accounts of Peoples Gas have been restated based on general partner interest and Common Units received by Peoples Gas in the merger.
- (c) EBITDA, as adjusted is presented because such information is relevant and is used by management, industry analysts, investors, lenders and rating agencies to assess the financial performance and operating results of the Partnership's fundamental business activities. Management believes that the presentation of EBITDA, as adjusted is useful to lenders and investors because of its use in the propane industry and for master limited partnerships as an indicator of the strength and performance of the Partnership's ongoing business operations, including the ability to fund capital expenditures, service debt and pay distributions. Additionally, management believes that EBITDA, as adjusted provides additional and useful information to the Partnership's investors for trending, analyzing and benchmarking the operating results of the Partnership from period to period as compared to other companies that may have different financing and capital structures. The presentation of EBITDA, as adjusted allows investors to view the Partnership's performance in a manner similar to the methods used by management and provides additional insight to the Partnership's operating results.

EBITDA, as adjusted is used by management to determine our operating performance, and along with other data as internal measures for setting annual operating budgets, assessing financial performance of the Partnership's numerous business locations, as a measure for evaluating targeted businesses for acquisition and as a measurement component of incentive compensation. The Partnership has a large number of business locations located in different regions of the United States. EBITDA, as adjusted can be a meaningful measure of financial performance because it excludes factors which are outside the control of the employees responsible for operating and managing the business locations, and provides information management can use to evaluate the performance of the business locations, or the region where they are located, and the employees responsible for operating them. To present EBITDA, as adjusted on a full Partnership basis, we add back the minority interest of the general partner because net income is reported net of the general partner's minority interest. Our EBITDA, as adjusted includes non-cash compensation expense which is a non-cash expense item resulting from our unit based compensation plans that does not require cash settlement and is not considered during management's assessment of the operating results of the Partnership's business. By adding these non-cash compensation expenses in EBITDA, as adjusted allows management to compare the Partnership's operating

results to those of other companies in the same industry who may have compensation plans with levels and values of annual grants that are

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different than the Partnership's. Other expenses include other finance charges and other asset non-cash impairment charges that are reflected in the Partnership's operating results but are not classified in interest, depreciation and amortization. We do not include gain on the sale of assets when determining EBITDA, as adjusted since including non-cash income resulting from the sale of assets increases the performance measure in a manner that is not related to the true operating results of the Partnership's business. In addition, Heritage's debt agreements contain financial covenants based on EBITDA, as adjusted. For a description of these covenants, please read "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations-Description of Indebtedness."

There are material limitations to using a measure such as EBITDA, as adjusted, including the difficulty associated with using it as the sole measure to compare the results of one company to another, and the inability to analyze certain significant items that directly affect a company's net income or loss. In addition, Heritage's calculation of EBITDA, as adjusted may not be consistent with similarly titled measures of other companies and should be viewed in conjunction with measurements that are computed in accordance with GAAP. EBITDA, as adjusted for the periods described herein is calculated in the same manner as presented by Heritage in the past. Management compensates for these limitations by considering EBITDA, as adjusted in conjunction with its analysis of other GAAP financial measures, such as gross profit, net income (loss), and cash flow from operating activities.

A reconciliation of EBITDA, as adjusted, to net income (loss) is presented below. Please read "-Reconciliation of EBITDA, As Adjusted to Net Income" below.

- (d) Capital expenditures fall generally into three categories: (i) maintenance capital expenditures of approximately \$12.8 and \$8.5 million in fiscal years 2002, and 2001, respectively, which include expenditures for repairs that extend the life of the assets and replacement of property, plant and equipment, (ii) growth capital expenditures, which include expenditures for purchase of new propane tanks and other equipment to facilitate retail customer base expansion, and (iii) acquisition expenditures which include expenditures related to the acquisition of retail propane operations and other business, and the portion of the purchase price allocated to intangibles associated with such acquired businesses.

PREDECESSOR HERITAGE

The following table sets forth, for the periods and as of the dates indicated, selected historical financial and operating data for Predecessor Heritage. The selected historical financial and operating data of Predecessor Heritage should be read in conjunction with the financial statements of Heritage Propane Partners, L.P. and its subsidiaries, (Predecessor Heritage) included elsewhere in this report and "Management's Discussion and Analysis of Financial Condition and Results of Operations" also included elsewhere in this report. The amounts in the table below, except per unit data, are in thousands.

HERITAGE PROPANE PARTNERS, L.P. (PREDECESSOR HERITAGE):

| Ten Months Ended June 30, | Two Months Ended August 31, | Years En August |
|------------------------------------|--------------------------------------|--------------------|
|------------------------------------|--------------------------------------|--------------------|

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| | 1996 (a) | 1996 | 1997 | 1998 |
|---|-----------|-----------|-----------|----------|
| Statements of Operating Data: | | | | |
| Revenues | \$144,623 | \$ 18,477 | \$199,785 | \$185,98 |
| Gross Profit (b) | 55,634 | 6,314 | 73,838 | 89,10 |
| Depreciation and amortization | 7,581 | 1,733 | 11,124 | 13,68 |
| Operating income (loss) | 15,755 | (1,956) | 16,919 | 22,92 |
| Interest expense | 10,833 | 1,962 | 12,063 | 14,59 |
| Income (loss) before income taxes and minority interest | 6,084 | (4,087) | 5,625 | 9,26 |
| Provision for income taxes | 2,735 | - | - | - |
| Net income (loss) | 2,921 | (8,423) | 5,177 | 8,79 |
| Basic and Diluted Net income (loss) per unit (c) | - | (1.06) | 0.64 | 1.0 |

18

| | August 31, | | | |
|--------------------------------------|------------|-----------|-----------|-----------|
| | 1996 | 1997 | 1998 | 1999 |
| Balance Sheet Data (end of period): | | | | |
| Current assets | \$ 24,014 | \$ 27,951 | \$ 26,185 | \$ 29,267 |
| Total assets | 187,850 | 203,799 | 239,964 | 262,958 |
| Current liabilities | 24,728 | 34,426 | 35,444 | 47,680 |
| Long-term debt | 132,521 | 148,453 | 177,431 | 196,216 |
| Partner's capital - general partner | 307 | 208 | 273 | 176 |
| Partners' capital - limited partners | 30,294 | 20,712 | 26,816 | 18,886 |

| | Years ended August 31, | | | | Period En |
|--------------------------------------|------------------------|-----------|-----------|-----------|-----------|
| | 1996 | 1997 | 1998 | 1999 | August |
| Operating Data (unaudited): | | | | | |
| EBITDA, as adjusted (d) | \$ 24,365 | \$ 28,718 | \$ 37,792 | \$ 41,047 | \$ 42,37 |
| Cash flows from operating activities | 12,325 | 15,384 | 24,532 | 23,613 | 14,14 |
| Cash flows from investing activities | (23,577) | (20,100) | (27,124) | (30,799) | (58,28 |
| Cash flows from financing activities | 26,673 | 5,571 | 2,404 | 7,028 | 44,58 |
| Capital expenditures (e) | | | | | |
| Maintenance and growth | 7,244 | 7,170 | 9,359 | 14,974 | 12,93 |
| Acquisition | 16,665 | 14,549 | 23,276 | 17,931 | 46,80 |
| Retail gallons sold | 118,200 | 125,605 | 146,747 | 159,938 | 170,89 |

(a) Reflects unaudited pro forma information for Predecessor Heritage as if the Partnership formation had occurred as of the beginning of the period presented.

(b) Gross profit is computed by reducing total revenues by the direct cost of the products sold.

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- (c) Net income (loss) per unit is computed by dividing the limited partners' interest in net income (loss) by the weighted average number of units outstanding.
- (d) EBITDA, as adjusted is defined as the Partnership's earnings before interest, taxes, depreciation, amortization and other non-cash items, such as compensation charges for unit issuances to employees, gain or loss on disposal of assets, and other expenses. We present EBITDA, as adjusted, on a Partnership basis which includes both the general and limited partner interests. Non-cash compensation expense represents charges for the value of the Common Units awarded under the Partnership's compensation plans that have not yet vested under the terms of those plans and are charges which do not, or will not, require cash settlement. Non-cash income such as the gain arising from our disposal of assets is not included when determining EBITDA, as adjusted. EBITDA, as adjusted (i) is not a measure of performance calculated in accordance with generally accepted accounting principles and (ii) should not be considered in isolation or as a substitute for net income, income from operations or cash flow as reflected in our consolidated financial statements.

EBITDA, as adjusted is presented because such information is relevant and is used by management, industry analysts, investors, lenders and rating agencies to assess the financial performance and operating results of the Partnership's fundamental business activities. Management believes that the presentation of EBITDA, as adjusted is useful to lenders and investors because of its use in the propane industry and for master limited partnerships as an indicator of the strength and performance of the Partnership's ongoing business operations, including the ability to fund capital expenditures, service debt and pay distributions. Additionally, management believes that EBITDA, as adjusted provides additional and useful information to the Partnership's investors for trending, analyzing and benchmarking the operating results of the Partnership from period to period as compared to other companies that may have different financing and capital structures. The presentation of EBITDA, as adjusted allows investors to view the Partnership's performance in a manner similar to the methods used by management and provides additional insight to the Partnership's operating results.

EBITDA, as adjusted is used by management to determine our operating performance, and along with other data as internal measures for setting annual operating budgets, assessing financial performance of the Partnership's numerous business locations, as a measure for evaluating targeted businesses for acquisition and as a measurement component of incentive compensation. The Partnership has a large number of business locations located in different regions of the

19

United States. EBITDA, as adjusted can be a meaningful measure of financial performance because it excludes factors which are outside the control of the employees responsible for operating and managing the business locations, and provides information management can use to evaluate the performance of the business locations, or the region where they are located, and the employees responsible for operating them. To present EBITDA, as adjusted on a full Partnership basis, we add back the minority interest of the general partner because net income is reported net of the general partner's minority interest. Our EBITDA, as adjusted includes non-cash compensation expense which is a non-cash expense item resulting from our unit based compensation plans that does not require cash settlement and is not considered during management's

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assessment of the operating results of the Partnership's business. By adding these non-cash compensation expenses in EBITDA, as adjusted allows management to compare the Partnership's operating results to those of other companies in the same industry who may have compensation plans with levels and values of annual grants that are different than the Partnership's. Other expenses include other finance charges and other asset non-cash impairment charges that are reflected in the Partnership's operating results but are not classified in interest, depreciation and amortization. We do not include gain on the sale of assets when determining EBITDA, as adjusted since including non-cash income resulting from the sale of assets increases the performance measure in a manner that is not related to the true operating results of the Partnership's business. In addition, Heritage's debt agreements contain financial covenants based on EBITDA, as adjusted. For a description of these covenants, please read "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations-Description of Indebtedness."

There are material limitations to using a measure such as EBITDA, as adjusted, including the difficulty associated with using it as the sole measure to compare the results of one company to another, and the inability to analyze certain significant items that directly affect a company's net income or loss. In addition, Heritage's calculation of EBITDA, as adjusted may not be consistent with similarly titled measures of other companies and should be viewed in conjunction with measurements that are computed in accordance with GAAP. EBITDA, as adjusted for the periods described herein is calculated in the same manner as presented by Heritage in the past. Management compensates for these limitations by considering EBITDA, as adjusted in conjunction with its analysis of other GAAP financial measures, such as gross profit, net income (loss), and cash flow from operating activities.

A reconciliation of EBITDA, as adjusted to net income (loss) is presented below. Please read "-Reconciliation of EBITDA, As Adjusted to Net Income" below.

- (e) Capital expenditures fall generally into three categories: (i) maintenance capital expenditures of approximately \$5.1 for the period ended August 9, 2000 and \$4.6, \$3.6 and \$2.3 million in fiscal years 1999, 1998 and 1997, respectively, which include expenditures for repairs that extend the life of the assets and replacement of property, plant and equipment, (ii) growth capital expenditures, which include expenditures for purchases of new propane tanks and other equipment to facilitate retail customer base expansion, and (iii) acquisition capital expenditures, which include expenditures related to the acquisition of retail propane operations and the portion of the purchase price allocated to intangibles associated with such acquired businesses.

RECONCILIATION OF EBITDA, AS ADJUSTED TO NET INCOME (LOSS)

The following tables set forth the reconciliation of EBITDA, as adjusted to net income (loss) Heritage Propane Partners, L.P. (formerly Peoples Gas Company) and Predecessor Heritage for the periods indicated:

HERITAGE PROPANE PARTNERS, L.P. (FORMERLY PEOPLES GAS):

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| NET INCOME RECONCILIATION | Years ended December 31, | | | Eight Months Ended August 31, | |
|--|--------------------------|----------|----------|-------------------------------|------------|
| | 1997 | 1998 | 1999 | 1999 | 2000 |
| Net income (loss) | \$ 602 | \$ 2,071 | \$ 1,768 | \$ 1,642 | \$ (3,846) |
| Depreciation and amortization | 2,514 | 2,855 | 3,088 | 2,037 | 4,686 |
| Interest | -- | -- | -- | -- | 2,409 |
| Taxes | 378 | 1,412 | 1,127 | 1,035 | 379 |
| Non-cash compensation expense | -- | -- | -- | -- | 549 |
| Other expenses | 390 | 478 | (10) | (11) | 478 |
| Depreciation, amortization, and interest and taxes of investee | -- | -- | -- | -- | 73 |
| Minority interest in the Operating Partnership | -- | -- | -- | -- | (100) |
| Less: Gain on disposal of assets | -- | -- | -- | -- | (121) |
| EBITDA, as adjusted (a) | \$ 3,884 | \$ 6,816 | \$ 5,973 | \$ 4,703 | \$ 4,507 |

(a) Please read footnote (c) under "Item 6. Selected Historical Financial and Operating Data - Heritage Propane Partners L.P. (formerly Peoples Gas)" and "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Description of Indebtedness" for a more detailed discussion of EBITDA, as adjusted.

HERITAGE PROPANE PARTNERS, L.P. (PREDECESSOR HERITAGE):

| NET INCOME RECONCILIATION | Years ended August 31, | | | |
|--|------------------------|-----------|-----------|-----------|
| | 1996 | 1997 | 1998 | 1999 |
| Net income (loss) | (5,502) | 5,177 | 8,790 | 9,662 |
| Depreciation and amortization | 9,314 | 11,124 | 13,680 | 14,749 |
| Extra ordinary loss on debt extinguishment | 4,361 | -- | -- | -- |
| Unrealized gain on investments | -- | -- | -- | -- |
| Interest | 12,795 | 12,063 | 14,599 | 15,915 |
| Taxes | 2,735 | -- | -- | -- |
| Non-cash compensation expense | -- | 92 | 218 | 361 |
| Other expenses | (223) | 74 | 307 | 264 |
| Depreciation, amortization, and interest and taxes of investee | 709 | 507 | 643 | 732 |
| Minority interest in the Operating Partnership | 403 | 53 | 89 | 86 |
| Less: Gain on disposal of assets | (227) | (372) | (534) | (722) |
| EBITDA, as adjusted (a) | \$ 24,365 | \$ 28,718 | \$ 37,792 | \$ 41,047 |

(a) Please read footnote (c) under "Item 6. Selected Historical Financial and Operating Data - Heritage Propane Partners, L.P. (formerly Peoples Gas)" and "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Description of Indebtedness" for a more detailed discussion of EBITDA, as adjusted.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following is a discussion of the historical financial condition and results of operations of Heritage Propane Partners, L.P. and its subsidiaries, formerly Peoples Gas and the surviving legal entity in the series of transactions with U.S. Propane, and should be read in conjunction with the historical Financial Statements of Peoples Gas and Predecessor Heritage and Notes thereto included elsewhere in this annual report on Form 10-K.

FORWARD-LOOKING STATEMENTS

21

CERTAIN MATTERS DISCUSSED IN THIS REPORT, EXCLUDING HISTORICAL INFORMATION, AS WELL AS SOME STATEMENTS BY HERITAGE IN PERIODIC PRESS RELEASES AND SOME ORAL STATEMENTS OF HERITAGE OFFICIALS DURING PRESENTATIONS ABOUT THE PARTNERSHIP, INCLUDE CERTAIN "FORWARD-LOOKING" STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933 AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934. STATEMENTS USING WORDS SUCH AS "ANTICIPATE," "BELIEVE," "INTEND," "PROJECT," "PLAN," "CONTINUE," "ESTIMATE," "FORECAST," "MAY," "WILL," OR SIMILAR EXPRESSIONS HELP IDENTIFY FORWARD-LOOKING STATEMENTS. ALTHOUGH HERITAGE BELIEVES SUCH FORWARD-LOOKING STATEMENTS ARE BASED ON REASONABLE ASSUMPTIONS AND CURRENT EXPECTATIONS AND PROJECTIONS ABOUT FUTURE EVENTS, NO ASSURANCE CAN BE GIVEN THAT EVERY OBJECTIVE WILL BE REACHED.

ACTUAL RESULTS MAY DIFFER MATERIALLY FROM ANY RESULTS PROJECTED, FORECASTED, ESTIMATED OR EXPRESSED IN FORWARD-LOOKING STATEMENTS SINCE MANY OF THE FACTORS THAT DETERMINE THESE RESULTS ARE DIFFICULT TO PREDICT AND ARE BEYOND MANAGEMENT'S CONTROL. SUCH FACTORS INCLUDE:

- CHANGES IN GENERAL ECONOMIC CONDITIONS IN THE UNITED STATES OF AMERICA AS WELL AS CHANGES IN GENERAL ECONOMIC CONDITIONS AND CURRENCIES IN FOREIGN COUNTRIES;
- WEATHER CONDITIONS THAT VARY SIGNIFICANTLY FROM HISTORICALLY NORMAL CONDITIONS WHICH MAY ADVERSELY AFFECT THE DEMAND FOR PROPANE AND HERITAGE'S FINANCIAL CONDITION;
- HERITAGE'S SUCCESS IN HEDGING ITS PRODUCT SUPPLY POSITIONS;
- THE EFFECTIVENESS OF RISK-MANAGEMENT POLICIES AND PROCEDURES AND THE ABILITY OF HERITAGE'S LIQUIDS MARKETING COUNTER PARTIES TO SATISFY THEIR FINANCIAL COMMITMENTS;
- THE GENERAL LEVEL OF PETROLEUM PRODUCT DEMAND AND THE AVAILABILITY AND PRICE OF PROPANE SUPPLIES;
- SUDDEN AND SHARP PROPANE PRICE INCREASES AND MARKET VOLATILITY MAY ADVERSELY AFFECT HERITAGE'S OPERATING RESULTS;
- THE POLITICAL AND ECONOMIC STABILITY OF PETROLEUM PRODUCING NATIONS;
- HERITAGE'S ABILITY TO CONDUCT BUSINESS IN FOREIGN COUNTRIES;
- HERITAGE'S ABILITY TO OBTAIN ADEQUATE SUPPLIES OF PROPANE FOR RETAIL SALE IN THE EVENT OF AN INTERRUPTION IN SUPPLY OR TRANSPORTATION;
- ENERGY PRICES GENERALLY AND SPECIFICALLY, THE PRICE OF PROPANE TO THE CONSUMER COMPARED TO THE PRICE OF ALTERNATIVE AND COMPETING FUELS;

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- THE MATURITY OF THE PROPANE INDUSTRY AND COMPETITION FROM OTHER PROPANE DISTRIBUTORS AND OTHER ENERGY SOURCES;
- ENERGY EFFICIENCIES AND TECHNOLOGICAL TRENDS MAY AFFECT DEMAND FOR PROPANE;
- THE AVAILABILITY AND COST OF CAPITAL;
- HERITAGE'S ABILITY TO ACCESS CERTAIN CAPITAL SOURCES MAY REQUIRE IT TO OBTAIN A DEBT RATING;
- CHANGES IN LAWS AND REGULATIONS TO WHICH HERITAGE IS SUBJECT, INCLUDING TAX, ENVIRONMENTAL, TRANSPORTATION, AND EMPLOYMENT REGULATIONS;
- OPERATING RISKS INCIDENTAL TO TRANSPORTING, STORING, AND DISTRIBUTING PROPANE, INCLUDING LITIGATION RISKS WHICH MAY NOT BE COVERED BY INSURANCE;
- HERITAGE'S ABILITY TO GENERATE AVAILABLE CASH FOR DISTRIBUTIONS TO UNITHOLDERS;

22

- THE COSTS AND EFFECTS OF LEGAL AND ADMINISTRATIVE PROCEEDINGS AGAINST HERITAGE OR WHICH MAY BE BROUGHT AGAINST IT;
- HERITAGE'S ABILITY TO SUSTAIN HISTORICAL LEVELS OF INTERNAL GROWTH;
- HERITAGE'S ABILITY TO CONTINUE TO LOCATE AND ACQUIRE OTHER PROPANE COMPANIES AT PURCHASE PRICES THAT ARE ACCRETIVE TO ITS FINANCIAL RESULTS;
- CASH DISTRIBUTIONS TO UNITHOLDERS ARE NOT GUARANTEED AND MAY FLUCTUATE WITH HERITAGE'S PERFORMANCE AND OTHER EXTERNAL FACTORS, INCLUDING RESTRICTIONS IN HERITAGE'S DEBT AGREEMENTS; AND
- HERITAGE MAY SELL ADDITIONAL LIMITED PARTNER INTERESTS, THUS DILUTING THE EXISTING INTEREST OF UNITHOLDERS.

GENERAL

The retail propane business is a "margin-based" business in which gross profits depend on the excess of sales price over propane supply costs. The market price of propane is often subject to volatile changes as a result of supply or other market conditions over which Heritage will have no control. Product supply contracts are one-year agreements subject to annual renewal and generally permit suppliers to charge posted prices (plus transportation costs) at the time of delivery or the current prices established at major delivery points. Since rapid increases in the wholesale cost of propane may not be immediately passed on to retail customers, such increases could reduce gross profits. Heritage generally has and Predecessor Heritage generally had attempted to reduce price risk by purchasing propane on a short-term basis. Heritage has and Predecessor Heritage had on occasion purchased significant volumes of propane during periods of low demand, which generally occur during the summer months, at the then current market price, for storage both at its customer service locations and in major storage facilities for future resale.

The retail propane business of Heritage consists principally of transporting propane purchased in the contract and spot markets, primarily from

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major fuel suppliers, to its customer service locations and then to tanks located on the customers' premises, as well as to portable propane cylinders. In the residential and commercial markets, propane is primarily used for space heating, water heating, and cooking. In the agricultural market, propane is primarily used for crop drying, tobacco curing, poultry brooding, and weed control. In addition, propane is used for certain industrial applications, including use as an engine fuel for internal combustion engines that power vehicles and forklifts and as a heating source in manufacturing and mining processes.

Heritage's propane distribution business is largely seasonal and dependent upon weather conditions in its service areas. Propane sales to residential and commercial customers are affected by winter heating season requirements. Historically, approximately two-thirds of Heritage's retail propane volume and in excess of 80% of Heritage's EBITDA, as adjusted is attributable to sales during the six-month peak-heating season of October through March. This generally results in higher operating revenues and net income during the period from October through March of each year and lower operating revenues and either net losses or lower net income during the period from April through September of each year. Consequently, sales and operating profits are concentrated in the first and second fiscal quarters, however, cash flow from operations is generally greatest during the second and third fiscal quarters when customers pay for propane purchased during the six-month peak-heating season. Sales to industrial and agricultural customers are much less weather sensitive

A substantial portion of Heritage's propane is used in the heating-sensitive residential and commercial markets causing the temperatures realized in Heritage's areas of operations, particularly during the six-month peak-heating season, to have a significant effect on its financial performance. In any given area, sustained warmer-than-normal temperatures will tend to result in reduced propane use, while sustained colder-than-normal temperatures will tend to result in greater propane use. Heritage uses information based on normal temperatures in understanding how temperatures that are colder or warmer than normal affect historical results of operations and in preparing forecasts of future operations.

23

Gross profit margins are not only affected by weather patterns, but also vary according to customer mix. For example, sales to residential customers generate higher margins than sales to certain other customer groups, such as commercial or agricultural customers. Wholesale margins are substantially lower than retail margins. In addition, gross profit margins vary by geographical region. Accordingly, a change in customer or geographic mix can affect gross profit without necessarily affecting total revenues.

The following is a discussion of the historical financial condition and results of operations of Heritage Propane Partners, L.P. and its subsidiaries, (Formerly Peoples Gas and the surviving legal entity in the series of transactions with U.S. Propane), and should be read in conjunction with the historical Financial and Operating Data and Notes thereto and the historical Financial and Operating Data and Notes thereto of Heritage Propane Partners, L.P. and its subsidiaries (Predecessor Heritage) included elsewhere in this annual report on Form 10-K.

ANALYSIS OF HISTORICAL RESULTS OF OPERATIONS - HERITAGE PROPANE PARTNERS, L.P.
(FORMERLY PEOPLES GAS)

The formation of U.S. Propane (formerly Peoples Gas) and the merger with Predecessor Heritage affect the comparability of (i) the fiscal year ended August 31, 2001 to the eight months ended August 31, 2000, because the volumes

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and results of operations of fiscal year 2001 include a full year of the volumes and results of operations of the propane operations of the combined operations, and (ii) the results of the eight months ended August 31, 2000 to the eight months ended August 31, 1999, because the volumes and results of operations for the period from August 10, 2000 through August 31, 2000 also include the volumes and results of operations of AGL, United Cities, Piedmont, and Predecessor Heritage. The increases in the line items discussed below are a result of these transactions. Amounts discussed below reflect 100% of the results of MP Energy Partnership during the period from August 9, 2000 through August 31, 2000 and the fiscal years ended August 31, 2001 and August 31, 2002. MP Energy Partnership is a general partnership in which Heritage owns a 60% interest. Because MP Energy Partnership is primarily engaged in lower-margin wholesale distribution, its contribution to Heritage's net income is not significant and the minority interest of this partnership is excluded from the EBITDA, as adjusted calculation.

FISCAL YEAR ENDED AUGUST 31, 2002 COMPARED TO THE FISCAL YEAR ENDED AUGUST 31, 2001

Volume. Total retail gallons sold in fiscal year 2002 were 329.6 million, a decrease of 0.6 million from the 330.2 million gallons sold in fiscal year 2001. This decrease resulted from an approximate 36.2 million gallon reduction in gallons sold primarily due to the significantly warmer than normal weather in fiscal year 2002, offset by an approximate 35.6 million gallon increase realized from acquisitions that were not included in the year ended August 31, 2001. Temperatures in the Partnership's area of operations were an average of 10% warmer than last year and 12% warmer than normal.

Heritage sold approximately 82.1 million wholesale gallons during fiscal year 2002 of which 16.8 million were domestic wholesale and 65.3 million were foreign wholesale. In fiscal year 2001, Heritage sold 12.7 million domestic wholesale gallons and 88.9 million foreign wholesale gallons. The increase of 4.1 million in domestic wholesale gallons in fiscal year 2002 compared to fiscal year 2001 is due to an approximate 10.1 million gallon increase related to acquisitions, offset by an approximate 6.0 million gallon decrease in volume sold primarily due to warmer temperatures in fiscal year 2002. The 23.6 million gallon decrease in foreign wholesale volumes is primarily due to a decrease in volume sold as a result of the warmer temperatures in fiscal year 2002.

Revenues. Total revenues for fiscal year 2002 were \$462.3 million, a decrease of \$81.6 million, as compared to \$543.9 million in fiscal year 2001. Retail revenues for fiscal year 2002 were \$365.3 million as compared to \$440.5 million for fiscal year 2001, a decrease of \$75.2 million, of which \$74.5 million was primarily due to lower selling prices and \$40.2 million was primarily due to the decrease in gallons sold as a result of warmer weather conditions, offset by an approximate \$39.5 million increase due to gallons added through acquisitions. Selling prices in all the reportable segments decreased from last year in response to lower supply costs. Domestic wholesale revenues increased \$0.1 million to \$10.0 million, due to an increase of approximately \$6.0 million in acquisition related volumes, offset by decreases of approximately \$2.3 million due to lower selling prices and approximately \$3.6 million related to a decrease in gallons sold as a result of the warmer weather conditions this fiscal year as compared to fiscal year 2001. Foreign wholesale revenues were \$31.2 million for fiscal year 2002 as compared to \$50.0 million for fiscal year 2001, a decrease of \$18.8 million primarily due to a combination of an approximate \$11.3 million in decreased volumes and an approximate \$7.5 million decrease related to lower selling prices. Net liquids marketing revenues decreased from \$0.8 million in fiscal year 2001 to \$0.5 million in fiscal year

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2002, primarily due to an overall reduction in the number of contracts entered into during fiscal year 2002 and lower commodity prices as compared to fiscal year 2001. Other domestic revenues increased by \$12.6 million to \$55.3 for fiscal year 2002, compared to \$42.7 million for fiscal year ended 2001 as a result of acquisitions and an increase in other service fees that are not weather sensitive.

Cost of Products Sold. Total cost of sales decreased \$68.4 million to \$238.2 million as compared to \$306.6 million for fiscal year 2001. Retail fuel cost of sales decreased \$53.5 million to \$184.6 million for fiscal year 2002, due to decreases in the cost of propane as compared to fiscal year 2001. Although the market price for propane for the year ended August 31, 2002 is well below the price for the year ended August 31, 2001, the average cost per gallon sold for fiscal year 2002 was negatively impacted by the higher cost of pre-bought inventory that was absorbed into cost of sales throughout the year ended August 31, 2002. U. S. wholesale cost of sales increased \$0.6 million due to an increase of approximately \$2.3 million as a result of acquisition volumes offset by an approximate \$1.7 million decrease due to lower cost of propane. Foreign wholesale cost of sales decreased \$18.7 million of which approximately \$10.6 million was due to decreased product costs this fiscal year and approximately \$ 8.1 million was due to decreased volumes described above. Other cost of sales increased \$3.2 million to \$14.6 million for fiscal year 2002 primarily due to acquisitions.

Gross Profit. Total gross profit decreased to \$224.1 million in fiscal year 2002 as compared to \$237.4 million in fiscal year 2001, due to the aforementioned decreases in volumes and revenues described above, offset in part by the decreases in product costs and the results of acquisitions. For fiscal year 2002, retail fuel gross profit was \$180.7 million, domestic wholesale gross profit was \$0.3 million, liquids marketing gross profit was \$0.5 million, other gross profit was \$40.6 million, and foreign wholesale gross profit was \$2.0 million. As a comparison, for fiscal year 2001, Heritage recorded retail fuel gross profit of \$202.4 million, domestic wholesale fuel gross profit of \$0.8 million, foreign gross profit of \$2.0 million, liquids marketing gross profit of \$1.5 million and other gross profit of \$30.7 million for a total gross profit of \$237.4 million.

Operating Expenses. Operating expenses were \$133.2 million for fiscal year 2002 as compared to \$126.8 million for fiscal year 2001. The increase of \$6.4 million is primarily the result of \$10.8 million of additional operating expenses incurred for employee wages and benefits related to the growth of Heritage from acquisitions since the fiscal year ended August 31, 2001, offset by a \$4.4 million decrease in the short-term incentive plan expense and cost reduction efforts initiated to address the decreased operating income encountered during the unusually warm winter of fiscal year 2002.

Selling, General and Administrative. Selling, general and administrative expenses were \$13.0 million for fiscal year 2002 as compared to \$15.7 million for fiscal year 2001. This decrease is primarily attributable to the additional expenses incurred in fiscal year 2001 related to the executive short-term compensation plan that did not reoccur during fiscal year 2002.

Depreciation and Amortization. Depreciation and amortization for fiscal year 2002 was \$37.0 million, a decrease of \$3.4 million as compared to \$40.4 million in fiscal year 2001. The decrease is primarily attributable to the adoption of FASB Statement No. 142, Goodwill and Other Intangible Assets ("SFAS 142") on September 1, 2001, which resulted in goodwill no longer being amortized. The adoption of SFAS 142 resulted in \$5.7 million less amortization expense for the year ended August 31, 2002. Goodwill amortization totaled \$4.9 million for the year ended August 31, 2001. This decrease was offset by increased depreciation related to property, plant and equipment, and intangible assets from the businesses acquired since the year ended August 31, 2001.

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Operating Income. Heritage reported operating income of \$41.0 million in fiscal year 2002 as compared to the operating income of \$54.4 million for fiscal year 2001. The decrease of \$13.4 million is due to the related decrease in gross profit and increase in operating expenses described above offset by the decrease in selling, general and administrative expenses and the decrease in depreciation and amortization previously discussed.

Interest Expense. Interest expense for fiscal year 2002 was \$37.3 million, an increase of \$1.7 million as compared to \$35.6 million in fiscal year 2001. In May 2001, Heritage issued \$70.0 million of fixed rate Senior Secured Notes. Interest expense related to these notes was recorded for four months in 2001 and twelve months in 2002, causing interest expense to increase approximately \$3.6 million in fiscal year 2002 compared to fiscal year 2001. This increase was offset by a \$0.6 million decrease in interest expense on the Working Capital Facility and a \$1.3 million decrease in interest expense on the Acquisition Facility.

25

Net Income. Heritage reported net income of \$4.9 million, or \$0.25 per limited partner unit, for fiscal year 2002, a decrease of \$14.8 million from net income of \$19.7 million for fiscal year 2001. This reduction is primarily due to the decreased operating income described above, and a \$1.8 million increase in interest expense, offset by a decrease in minority interest expense due to decreased net income, a decrease in other expenses, and an increase in earnings from affiliates.

EBITDA, as adjusted. EBITDA, as adjusted decreased \$15.9 million to \$81.5 million for fiscal year 2002, as compared to EBITDA, as adjusted of \$97.4 million for fiscal year 2001. This decrease is related to the decrease in gross margin realized during the year ended August 31, 2002 as compared to the year ended August 31, 2001, resulting in reduced operating income. EBITDA, as adjusted is not a measure of performance calculated in accordance with generally accepted accounting principles, and should not be considered in isolation or as a substitute for net income, income from operations or cash flow as reflected in our consolidated financial statements. Please read footnote (c) under "Item 6. Selected Historical Financial and Operating Data - Heritage Propane Partners, L.P. (formerly Peoples Gas)" and "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Description of Indebtedness" for a more detailed discussion of EBITDA, as adjusted.

FISCAL YEAR ENDED AUGUST 31, 2001 COMPARED TO THE EIGHT MONTHS ENDED AUGUST 31, 2000

Volume. Total retail gallons sold in the year ended August 31, 2001 were 330.2 million, an increase of 291.9 million over the 38.3 million gallons sold in the eight months ended August 31, 2000. Predecessor Heritage sold 170.9 million retail gallons in the approximate eleven-month period ended August 9, 2000. Of the 159.3 million gallon increase, approximately 51.9 million gallons due to a return to more normal weather during the peak-heating season, and approximately 107.4 million gallons were attributable to acquisitions.

Heritage sold approximately 101.6 million wholesale gallons during fiscal year 2001 of which 12.7 million were domestic wholesale and 88.9 million were foreign wholesale. In the eight months ended August 31, 2000, Heritage sold 0.6 million domestic wholesale gallons and 6.2 million foreign wholesale gallons. The increase in wholesale gallons is attributable to having a full year of the operations of Predecessor Heritage reported in fiscal year 2001, as Peoples Gas did not have any wholesale gallons that were reported in the eight months ended August 31, 2000. As a comparison, Predecessor Heritage sold approximately 82.6

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million wholesale gallons in the eleven-month period ended August 9, 2000 of which 7.1 million were domestic wholesale and 75.5 million were foreign wholesale. This 19.0 million gallon increase was primarily due to a return to more normal weather during the peak-heating season of 2001.

Revenues. Total revenues for the fiscal year ended August 31, 2001 were \$543.9 million an increase of \$492.4 million as compared to \$51.5 million in the eight months ended August 31, 2000. Revenues for the propane operations of Predecessor Heritage for the approximate eleven-month period ended August 9, 2000 were \$242.5 million. Retail revenues for the fiscal year ended August 31, 2001 were \$440.5 million as compared to \$43.8 million for the eight months ended August 31, 2000, an increase of \$396.7 million. Predecessor Heritage reported retail fuel revenues of \$178.9 million in the eleven months ended August 9, 2000. Of the increase of \$261.6 million in retail revenues for fiscal year ended August 31, 2001 as compared to Predecessor Heritage eleven months ended August 9, 2000, approximately \$143.3 million was due to acquisitions, approximately \$49.1 million was due to higher selling prices, and approximately \$69.2 million was due to an increase in gallons sold as a result of the return to more normal weather patterns. Domestic wholesale revenues were \$9.9 million, foreign wholesale revenues were \$50.0 million and other revenues were \$42.7 million for the fiscal year ended August 31, 2001. Heritage also had net revenues from its liquids marketing activities of \$0.8 million for fiscal year 2001, which began operations in June 2000. For the eight months ended August 31, 2000, Heritage reported domestic wholesale revenues of \$0.4 million, foreign wholesale revenues of \$3.4 million, other revenues of \$3.2 million, and net revenues from liquids marketing activities of \$0.7 million. A full year of the combined operations of the propane operations of U.S. Propane, Predecessor Heritage and the additional acquisitions made by Heritage attributed to the increases in the revenues, along with the increase in gallons, due to the return of more normal weather patterns, higher selling prices and the effect of the operations of previous acquisitions in fiscal year 2001 as compared to periods reported last year.

Cost of Products Sold. Total cost of products sold in fiscal year 2001 increased \$276.6 million to \$306.6 million as compared to \$30.0 million for the eight months ended August 31, 2000. Retail fuel cost of sales were \$238.1 million for the fiscal year ended August 31, 2001, an increase of \$212.7 million, as compared to \$25.4 million for the eight months ended August 31, 2000. Predecessor Heritage reported total cost of sales of \$140.8

26

million in the eleven-month period ended August 9, 2000, of which \$95.1 million was for retail fuel cost of sales. Of the \$143 million increase in retail cost of sales, approximately \$37.4 million was due to an increase in volumes sold, approximately \$77.5 million was due to acquisitions, and approximately \$28.1 million was due to higher wholesale cost of fuel for the fiscal year ended August 31, 2001 as compared to the eight-month period ended August 31, 2000. Wholesale cost of sales increased \$53.4 million of which \$44.7 million was related to foreign cost of sales. Other cost of sales increased to \$11.4 million as compared to \$1.0 million due to a full year of the combined operations of the propane operations of U.S. Propane and Predecessor Heritage coupled with the acquisitions made during fiscal year 2001. Fuel cost of sales increased due to the increases in volumes described above and due to the significantly higher wholesale cost of propane for fiscal year ended August 31, 2001 as compared to the eight-month period last year.

Gross Profit. Total gross profit increased to \$237.4 million in fiscal year 2001 as compared to \$21.6 million for the eight months ended August 31, 2000. This increase is due to the aforementioned increases in volumes and revenues, offset by the increase in product costs. For the fiscal year ended August 31, 2001, retail fuel gross profit was \$202.4 million, domestic wholesale

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fuel gross profit was \$0.8 million, and other gross profit was \$30.7 million. Foreign wholesale gross profit was \$2.0 million and liquids marketing gross profit was \$1.4 million for the fiscal year ended August 31, 2001. As a comparison, for the eleven-month period ended August 9, 2000, Predecessor Heritage recorded retail fuel gross profit of \$83.8 million, wholesale fuel gross profit of \$0.6 million, foreign gross profit of \$1.5 million and other of \$15.8 million, for a total gross profit of \$101.7 million.

Operating Expenses. Operating expenses were \$126.8 million for fiscal year 2001 as compared to \$16.6 million for the eight-month period ended August 31, 2000. The increase of \$110.2 million is the result of the additional operating expenses related to a full year of the combined propane operations of U.S. Propane, Predecessor Heritage, and the additional acquisitions made by Heritage. Predecessor Heritage reported operating expenses of \$55.1 million in the eleven-month period ended August 9, 2000.

Selling, General and Administrative. Selling, general and administrative expenses were \$15.7 million for the fiscal year ended August 31, 2001 as compared to \$1.0 million for the eight months ended August 31, 2000. Peoples Gas did not classify any of its operating expenses as selling, general and administrative, so as a comparison Predecessor Heritage had selling, general and administrative, expenses of \$6.0 million for the eleven month period ended August 31, 2000. The increase in selling, general and administrative expenses is primarily due to the growth of Heritage resulting from the merger of U.S. Propane and Predecessor Heritage, other acquisitions, and the additional executive compensation that relates to fiscal year 2001 operating performance.

Depreciation and Amortization. Depreciation and amortization for the fiscal year ended August 31, 2001 was \$40.4 million, an increase of \$35.7 million as compared to \$4.7 million in the eight months ended August 31, 2000. The increase is primarily attributable to the addition of property, plant and equipment, and intangible assets from the transactions referred to above.

Operating Income (Loss). Heritage reported net income of \$54.4 million in fiscal year 2001 as compared to the operating loss of \$0.7 million for the eight months ended August 31, 2000. Predecessor Heritage reported operating income of \$23.5 million for the eleven-month period ended August 9, 2000. The increases in gross profit above, offset by the increases in operating and selling, general and administrative expenses and depreciation and amortization, attributed to the increase in operating income.

Interest Expense. Interest expense for fiscal year 2001 was \$35.6 million as compared to \$2.4 million for the eight months ended August 31, 2000. Predecessor Heritage reported interest expense of \$17.6 million for the eleven-month period ended August 9, 2000. The increase in fiscal year 2001 is primarily due to the interest on \$180.0 million in Senior Secured Notes issued in August 2001 and other related debt assumed from Predecessor Heritage.

Provision for Income Taxes. Heritage did not report a provision for income taxes for fiscal year 2001. Heritage is a limited partnership and as a result, its earnings or loss for federal income tax purposes is included in the tax returns of the individual partners. Provision for income taxes was \$0.4 million in the eight months ended August 31, 2000, which represents the provision for income taxes incurred prior to the transactions with Predecessor Heritage. Prior to the transaction with Predecessor Heritage, Peoples Gas filed a consolidated federal income tax

return with TECO and, based on a tax sharing agreement, included, in its statements of operations, a provision for income taxes calculated on a separate

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return basis.

Net Income (Loss). Heritage reported a record net income of \$19.7 million, or \$1.43 per limited partner unit, for the fiscal year ended August 31, 2001, an increase of \$23.5 million over the net loss of \$3.8 million for the eight-month period ended August 31, 2000. Predecessor Heritage reported net income of \$6.5 million or \$0.66 per limited partner unit for the eleven-month period ended August 9, 2000. The increase in net income over the eight-month period ended August 31, 2000 and the eleven-month period ended August 9, 2000, was the result of the increase in operating income described above, plus a nonrecurring gain of \$0.8 million on the sale of excess property offset by an increase of \$33.2 million of interest expense over the interest expense reported in eight months ended August 31, 2000. Interest expense for fiscal year 2001 increased due to the increase of debt incurred in the transaction with U.S. Propane.

EBITDA, as adjusted. EBITDA, as adjusted increased \$92.9 million to \$97.4 million for the year ended August 31, 2001, as compared to the EBITDA, as adjusted of \$4.5 million for the eight month period ended August 31, 2000. The EBITDA, as adjusted for Predecessor Heritage for the eleven-month period ended August 9, 2000 was \$42.4 million. EBITDA, as adjusted is not a measure of performance calculated in accordance with generally accepted accounting principles, and should not be considered in isolation or as a substitute for net income, income from operations or cash flow as reflected in our consolidated financial statements. Please read footnote (c) under "Item 6. Selected Historical Financial and Operating Data - Heritage Propane Partners, L.P. (formerly Peoples Gas)" and "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Description of Indebtedness" for a more detailed discussion of EBITDA, as adjusted.

EIGHT MONTHS ENDED AUGUST 31, 2000 COMPARED TO THE EIGHT MONTHS ENDED AUGUST 31, 1999 (UNAUDITED)

Volume. Total retail gallons sold in the eight months ended August 31, 2000 were 38.3 million, an increase of 16.2 million over the 22.1 million gallons sold in the eight months ended August 31, 1999. Heritage sold 16.3 million retail gallons in the period from August 10, 2000 through August 31, 2000, thus the increase in retail gallons is primarily attributable to the transactions referred to above.

Revenues. Total revenues for the eight months ended August 31, 2000 were \$63.1 million, an increase of \$41.3 million as compared to \$21.8 million for the eight months ended August 31, 1999. Revenues for the former propane operations of Predecessor Heritage for the period from August 10, 2000 through August 31, 2000 were \$36.4 million, of which \$11.7 million was due to the liquids marketing activity and the remainder related to increased volumes. The increase in revenue is primarily attributable to the transactions referred to above.

Cost of Products Sold. Total cost of products sold increased \$33.0 million to \$41.5 million for the eight months ended August 31, 2000. Of this increase, \$11.5 million is the result of the liquids marketing activity for the period from August 10, 2000 through August 31, 2000, with the remainder relating to the increased volumes described above.

Operating Expenses. Operating expenses were \$16.6 million for the eight-month period ended August 31, 2000 as compared to \$8.6 million for the eight months ended August 31, 1999. The increase of \$8.0 million is the result of the additional operating expense related to the merger.

Depreciation and Amortization. Depreciation and amortization was \$4.7 million in the eight months ended August 31, 2000 as compared to \$2.0 million in the eight months ended August 31, 1999. The increase is attributable to the transactions referred to above.

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Operating Income (Loss). Heritage had an operating loss of \$0.7 million for the eight months ended August 31, 2000 as compared to operating income of \$2.7 million for the eight months ended August 31, 1999. The decrease is the result of the additional operating expenses and depreciation and amortization resulting from the merger.

Provision for Income Taxes. Provision for income taxes decreased \$0.6 million, to \$0.4 million for the eight months ended August 31, 2000, as compared to \$1.0 million for the eight months ended August 31, 1999. This decrease is a result of the decrease in income before provision for income taxes in the comparable eight-month

28

period of Peoples Gas. Prior to the transaction with Predecessor Heritage, Peoples Gas filed a consolidated federal income tax return with TECO and, based on a tax sharing agreement, included, in its statements of operations, a provision for income taxes calculated on a separate return basis.

Net Income (Loss). For the eight-month period ended August 31, 2000, Heritage had a net loss of \$3.8 million, a decrease of \$5.4 million as compared to net income for the eight months ended August 31, 1999 of \$1.6 million. This decrease is the result of decreased operating income described above.

LIQUIDITY AND CAPITAL RESOURCES

The ability of Heritage to satisfy its obligations will depend on its future performance, which will be subject to prevailing economic, financial, business, and weather conditions, and other factors, many of which are beyond its control. Future capital requirements of Heritage are expected to be provided by cash flows from operating activities. To the extent future capital requirements exceed cash flows from operating activities:

- a) working capital will be financed by the working capital line of credit and repaid from subsequent seasonal reductions in inventory and accounts receivable;
- b) growth capital, mainly for customer tanks, expended will be financed by the revolving acquisition line of credit; and
- c) acquisition capital expenditures will be financed by the revolving acquisition line of credit, other lines of credit, long-term debt, the issuance of additional Common Units or a combination thereof.

Cash Flows

Operating Activities. Cash provided by operating activities for fiscal year 2002 was \$65.4 million as compared to cash provided by operating activities of \$28.1 million for fiscal year 2001. The net cash provided from operations of \$65.4 million for the fiscal year ended August 31, 2002 consisted of net income of \$4.9 million and noncash charges of \$37.9 million, primarily depreciation and amortization, and a decrease in working capital items of \$22.6 million. Working capital items have decreased in fiscal year 2002 from fiscal year 2001, as Heritage had secured a substantial amount of inventory and inventory positions as of August 31, 2001, to protect winter's propane supply from anticipated unfavorable market dynamics that were not present at the end of fiscal year 2002, and the collection of high accounts receivable balances from the cold winter of fiscal year 2001.

Investing Activities. Heritage completed ten acquisitions during the

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fiscal year ended August 31, 2002 investing \$19.7 million, net of cash received. This capital expenditure amount is reflected in the cash used in investing activities of \$33.4 million along with \$12.8 million invested for maintenance needed to sustain operations at current levels and \$14.3 million for customer tanks and other expenditures to support growth of operations. Investing activities also includes proceeds from the sale of property of \$13.3 million, of which \$3.6 million was for the sale of idle property and \$9.7 million was for the sale of certain assets acquired in the ProFlame acquisition to Bi-State Propane. This sale was made pursuant to the provision in the Bi-State Propane partnership agreement that requires each partner to offer to sell any newly acquired businesses within Bi-State Propane's area of operations to Bi-State Propane. In conjunction with this sale, the Operating Partnership guaranteed \$5 million of debt incurred by Bi-State Propane to a financial institution.

Financing Activities. Cash used in financing activities of \$33.1 million during the fiscal year ended August 31, 2002, was primarily a net increase in short-term debt of \$10.3 million and a net decrease in long-term debt of \$2.2 million, offset by \$41.2 million of cash distributions paid to Unitholders and the General Partner.

Financing and Sources of Liquidity

Heritage has a Bank Credit Facility with various financial institutions, which includes a Working Capital Facility, providing for up to \$65.0 million of borrowings to be used for working capital and other general partnership purposes, and an Acquisition Facility, providing for up to \$50.0 million of borrowings to be used for acquisitions and improvements. The Working Capital Facility expires June 30, 2004 and the Acquisition Facility expires December 31, 2003, at which time the facility will convert to a term loan payable in quarterly installments with a

29

final maturity of June 30, 2006. The weighted average interest rate was 3.675% for the amounts outstanding at August 31, 2002 on both the Working Capital Facility and the Acquisition Facility. At August 31, 2002, there was \$34.8 million available for borrowing on the Working Capital Facility and \$36.0 million available on the Acquisition Facility. See Note 4 - "Working Capital Facility and Long-Term Debt" to the Consolidated Financial Statements beginning on Page F-1 of this report.

The Partnership uses its cash provided by operating and financing activities to provide distributions to Unitholders and to fund acquisition, maintenance, and growth capital expenditures. Acquisition capital expenditures, which include expenditures related to the acquisition of retail propane operations and intangibles associated with such acquired businesses, were \$19.7 million for the fiscal year ended August 31, 2002 as compared to \$94.9 million for fiscal year 2001. In addition to the \$19.7 million of cash expended for acquisitions during fiscal year 2002, \$2.7 million for notes payable on non-compete agreements were issued in connection with certain acquisitions. In comparison, in addition to the \$94.9 million of cash expended for acquisitions during the fiscal year ended August 31, 2001, \$6.0 million of Common Units and \$10.0 million for notes payable on non-compete agreements were issued in connection with certain acquisitions.

Under the Partnership Agreement, the Partnership will distribute to the General Partner and its Limited Partners, 45 days after the end of each fiscal quarter, an amount equal to all of its Available Cash for such quarter. Available cash generally means, with respect to any quarter of the Partnership, all cash on hand at the end of such quarter less the amount of cash reserves established by the General Partner in its reasonable discretion that is

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necessary or appropriate to provide for future cash requirements. The Partnership's commitment to its Unitholders is to distribute the increase in its cash flow while maintaining prudent reserves for the Partnership's operations. The Partnership raised the quarterly distribution \$0.0125 per unit for the first quarter of fiscal year 2002 from the \$0.625 per unit distribution paid on October 15, 2001 for the fourth quarter ended August 31, 2001, to the current level of \$0.6375 per unit (or \$2.55 annually). The current distribution level includes incentive distributions payable to the General Partner to the extent the quarterly distribution exceeds \$0.55 per unit (\$2.20 annually).

The assets utilized in the propane business do not typically require lengthy manufacturing process time or complicated, high technology components. Accordingly, the Partnership does not have any significant financial commitments for capital expenditures. In addition, the Partnership has not experienced any significant increases attributable to inflation in the cost of these assets or in its operations.

DESCRIPTION OF INDEBTEDNESS

Predecessor Heritage assumed \$120 million principal amount of 8.55% Senior Secured Notes (the "Notes") at the formation of the Partnership in a private placement with institutional investors. Interest is payable semi-annually in arrears on each December 31 and June 30. The Notes have a final maturity of June 30, 2011, with ten equal mandatory repayments of principal, which began on June 30, 2002.

On November 19, 1997, Predecessor Heritage entered into a Note Purchase Agreement ("Medium Term Note Program") that provided for the issuance of up to \$100 million of senior secured promissory notes if certain conditions were met. An initial placement of \$32 million (Series A and B), at an average interest rate of 7.23% with an average 10-year maturity, was completed at the closing of the Medium Term Note Program. Interest is payable semi-annually in arrears on each November 19 and May 19. An additional placement of \$15 million (Series C, D and E), at an average interest rate of 6.59% with an average 12-year maturity, was completed in March 1998. Interest is payable on Series C, D and E semi-annually in arrears on each September 13 and March 13. The proceeds of the placements were used to refinance amounts outstanding under the Acquisition Facility. No future placements are permitted under the unused portion of the Medium Term Note Program.

On August 10, 2000, Heritage entered into a Note Purchase Agreement ("Senior Secured Promissory Notes") that provided for the issuance of up to \$250 million of fixed rate senior secured promissory notes if certain conditions were met. An initial placement of \$180 million (Series A through F) at an average rate of 8.66% with an average 13-year maturity, was completed in conjunction with the merger with U.S. Propane. Interest is payable quarterly. The proceeds were used to finance the transaction with U.S. Propane and retire a portion of existing debt. On May 24, 2001, Heritage issued an additional \$70 million (Series G through I) of the Senior Secured Promissory Notes to a group of institutional lenders with 7-, 12- and 15-year maturities and an average coupon rate of 7.66%.

30

Heritage used the net proceeds from the Senior Secured Promissory Notes to repay the balance outstanding under the Acquisition Facility and to reduce other debt. Interest is payable quarterly.

The Note Agreements for each of the Notes, Medium Term Note Program and Senior Secured Promissory Notes, and the Bank Credit Facility contain customary restrictive covenants applicable to the Operating Partnership, including

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limitations on the level of additional indebtedness, creation of liens, and sale of assets. These covenants require the Operating Partnership to maintain ratios of Consolidated Funded Indebtedness to Consolidated EBITDA (as these terms are similarly defined in the Bank Credit Facility and the Note Agreements) of not more than 5.00 to 1 for the Bank Credit Facility and not more than 5.25 to 1 for the Note Agreements and Consolidated EBITDA to Consolidated Interest Expense (as these terms are similarly defined in the Bank Credit Facility and the Note Agreements) of not less than 2.25 to 1. The Consolidated EBITDA used to determine these ratios is calculated in accordance with these debt agreements. For purposes of calculating the ratios under the Bank Credit Facility and the Note Agreements, Consolidated EBITDA is based upon Heritage's EBITDA, as adjusted during the most recent four quarterly periods and modified to give pro forma effect for acquisitions and divestitures made during the test period, and is compared to Consolidated Funded Indebtedness as of the test date and the Consolidated Interest Expense for the most recent twelve months. The debt agreements also provide that the Operating Partnership may declare, make, or incur a liability to make, a restricted payment during each fiscal quarter, if: (a) the amount of such restricted payment, together with all other restricted payments during such quarter, do not exceed Available Cash with respect to the immediately preceding quarter; and (b) no default or event of default exists before such restricted payment and after giving effect thereto. The debt agreements further provide that Available Cash is required to reflect a reserve equal to 50% of the interest to be paid on the notes. In addition, in the third, second and first quarters preceding a quarter in which a scheduled principal payment is to be made on the notes, Available Cash is required to reflect a reserve equal to 25%, 50%, and 75%, respectively, of the principal amount to be repaid on such payment dates.

Failure to comply with the various restrictive and affirmative covenants of the Operating Partnership's Bank Credit Facility and the Note Agreements could negatively impact the Operating Partnership's ability to incur additional debt and Heritage's ability to pay distributions. The Operating Partnership is required to measure these financial tests and covenants quarterly and was in compliance with all requirements, tests, limitations, and covenants related to the Notes, Medium Term Note Program, Senior Secured Promissory Notes, and the Bank Credit Facility at August 31, 2002.

The following table summarizes our long-term debt and other contractual obligations as of August 31, 2002:

| Contractual Obligations | Payments Due by Period | | | | |
|-----------------------------|------------------------|---------------------|----------------|----------------|----------------------|
| | Total | Less Than 1 Year | 1 - 3 Years | 3 - 5 Years | More Than 5 Years |
| Long-term debt | \$440,179 | \$ 20,158 | \$ 71,320 | \$ 92,043 | \$256,658 |
| Operating lease obligations | 7,515 | 2,864 | 2,899 | 1,038 | 714 |
| Totals | \$447,694 | \$ 23,022 | \$ 74,219 | \$ 93,081 | \$257,372 |

See Note 4 - "Working Capital Facility and Long-Term Debt" to the Consolidated Financial Statements beginning on Page F-1 of this report for further discussion of the long-term debt classifications and the maturity dates and interest rates related to long-term debt.

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NEW ACCOUNTING STANDARDS

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement No. 142, Goodwill and Other Intangible Assets (SFAS 142). Under SFAS 142, goodwill is no longer subject to amortization over its estimated useful life. Rather, goodwill will be subject to at least an annual assessment for impairment by applying a fair-value-based test. Additionally, any acquired intangible assets 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. Those assets will be amortized over their useful lives, other than assets that have an indefinite life. Heritage adopted SFAS 142 on September 1, 2001 and accordingly has discontinued the amortization of goodwill existing at the time of adoption. Under the provisions of SFAS 142, Heritage was required to perform a transitional goodwill impairment appraisal within six months from the time of adoption. Management engaged an independent appraisal firm to perform an assessment of the fair value of each of Heritage's operating segments, which were compared with the carrying value of each segment to determine whether any impairment existed on the date of adoption. Heritage has completed the transitional goodwill impairment appraisal and has determined that based on the fair value of Heritage's operating segments, Heritage's goodwill was not impaired as of September 1, 2001.

In June 2001, the FASB issued Statement No. 143, Accounting for Asset Retirement Obligations (SFAS 143). SFAS 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. Heritage adopted the provisions of SFAS 143 on September 1, 2002. The adoption of SFAS 143 did not have a material impact on the Partnership's consolidated financial condition or results of operations.

In August 2001, the FASB issued Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144). SFAS 144 supersedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of (SFAS 121), and the accounting and reporting provisions of APB Opinion No. 30, Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions. SFAS 144 retains the fundamental provisions of SFAS 121 for recognition and measurement of the impairment of long-lived assets to be held and used, and measurement of long-lived assets to be disposed of by sale. SFAS 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001 and interim periods within those fiscal years, with early application encouraged. Heritage adopted the provisions of SFAS 144 on September 1, 2002. The adoption of SFAS 144 did not have a material impact on the Partnership's consolidated financial condition or results of operations.

In April 2002, the FASB issued Statement No. 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections (SFAS 145). SFAS 145 rescinds FASB Statement No. 4, Reporting Gains and Losses from Extinguishment of Debt, and an amendment of that Statement, FASB Statement No. 64, Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements. SFAS 145 also rescinds FASB Statement No. 44, Accounting for Intangible Assets of Motor Carriers, amends FASB Statement No 13, Accounting for Leases, to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback

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transactions and also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. SFAS 145 is effective for fiscal years beginning after May 15, 2002 with early application encouraged. Heritage adopted the provisions of SFAS 145 on September 1, 2002. The adoption did not have a material impact on the Partnership's consolidated financial condition or results of operations.

In June 2002, the FASB issued Statement No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146). SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and requires that a liability for a cost associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. Heritage adopted the provisions of SFAS 146 effective for exit or disposal activities that are initiated after December 31, 2002. The adoption did not have a material impact on the Partnership's consolidated financial position or results of operations.

32

In October 2002, the EITF of the FASB discussed EITF Issue No. 02-3, Issues Related to Accounting for Contracts Involved in Energy Trading and Risk Management Activities (EITF 02-3). The EITF reached a consensus to rescind EITF Issue No. 98-10, Accounting for Contracts Involved in Energy Trading and Risk Management Activities (EITF 98-10), the impact of which is to preclude mark-to-market accounting for energy trading contracts not within the scope of SFAS 133. The EITF also reached a consensus that gains and losses on derivative instruments within the scope of SFAS 133 should be shown net in the statement of operations if the derivative instruments are held for trading purposes and what the disclosure requirements should be. This consensus was effective for financial statements issued for periods ending after July 15, 2002. Heritage adopted EITF 02-3 as of August 31, 2002, and upon application reclassified comparative financial statements for prior periods to conform to the consensus. This adoption did not have a material impact on Heritage's financial position or results of operations. The consensus regarding the rescission of EITF 98-10 is applicable for fiscal periods beginning after December 15, 2002. Energy trading contracts not within the scope of SFAS 133 purchased after October 25, 2002, but prior to the implementation of the consensus are not permitted to apply mark-to-market accounting. The adoption of EITF 02-3 as it relates to the rescission of EITF 98-10 is not expected to have a material impact on Heritage's financial position or results of operations.

In December 2002, the FASB issued Statement No. 148 Accounting for Stock-Based Compensation - Transition and Disclosure (SFAS 148). The statement amends FASB Statement No. 123 Accounting for Stock-Based Compensation (SFAS 123) to provide alternative methods of transitions for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The provisions of SFAS 148 are effective for fiscal years ending after July 31, 2003, with earlier application permitted, and the interim disclosure requirements of SFAS 148 are effective for periods beginning after December 15, 2002. Heritage adopted the fair value recognition provisions of SFAS 123 effective as of September 1, 2002. Heritage adopted the fair value recognition provisions following the modified prospective method of adoption described in SFAS 123. Following adoption, deferred compensation expense that will be recognized will be the same as that which would have been recognized had the fair value recognition provisions of SFAS 123 been applied to all awards granted under the Restricted Unit Plan and the Long Term Incentive Plan granted after its original effective date. Results from prior years have not been restated.

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In April 2003, the FASB issued Statement No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities (SFAS 149). SFAS 149 amends and clarifies financial accounting and reporting for derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under SFAS 133. SFAS 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. Heritage adopted SFAS 149 as of July 1, 2003. The adoption of SFAS 149 did not have a material impact on the Partnership's consolidated financial position or results of operations.

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

In November 2002, the FASB issued Financial Interpretation No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" (FIN 45). FIN 45 expands the existing disclosure requirements for guarantees and requires that companies recognize a liability for guarantees issued after December 31, 2002. The implementation of FIN 45 did not have a significant impact on Heritage's financial position or results of operations.

In January 2003, the FASB issued Financial Interpretation No. 46 Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51 (FIN 46). FIN 46 clarifies Accounting Research Bulletin No. 51, Consolidated Financial Statements. If certain conditions are met, this interpretation requires the primary beneficiary to consolidate certain variable interest entities in which equity investors lack the characteristics of a controlling interest or do not have sufficient equity investment at risk to permit the variable interest entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for variable interest entities created or obtained after January 31, 2003. For variable interest entities acquired before February 1, 2003, the interpretation is effective for the first fiscal year or interim period beginning after June 15, 2003. Management does not believe FIN 46 will have a significant impact on the Partnership's financial position.

33

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to establish accounting policies and make estimates and assumptions that affect reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Heritage evaluates its policies and estimates on a regular basis. Actual results could differ from these estimates.

The Partnership's significant accounting policies are discussed in Note 2 -- "Summary of Significant Accounting Policies and Balance Sheet Detail" to the Consolidated Financial Statements beginning on page F-1 of this report. Heritage believes the following are critical accounting policies:

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Principles of Consolidation. The consolidated financial statements of the Partnership include the accounts of its subsidiaries, including the Operating Partnership, MP Energy Partnership, Heritage Service Corp., Guilford Gas Service, Inc., Heritage Energy Resources, LLC ("Resources") and the Propane LLCs. A minority interest liability and minority interest expense is recorded for all partially owned subsidiaries. Heritage accounts for its 50% partnership interest in Bi-State Propane, another propane retailer, under the equity method. All significant intercompany transactions and accounts have been eliminated in consolidation. For purposes of maintaining partner capital accounts, Heritage's Partnership Agreement specifies that items of income and loss shall be allocated among the partners in accordance with their percentage interests. Normal allocations according to percentage interests are made, however, only after giving effect to any priority income allocations in an amount equal to the incentive distributions that are allocated 100% to the General Partner. At August 31, 2002, as successor General Partner, U.S. Propane's 1.0101% general partner interest in the Operating Partnership was accounted for in the consolidated financial statements as a minority interest. For the year ended August 31, 2001, Heritage Holdings' 1.0101% general partner interest and U.S. Propane's 1.0101% limited partner interest in the Operating Partnership were accounted for in the consolidated financial statements as minority interests.

Property, Plant and Equipment. Property, plant and equipment is stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Expenditures for maintenance and repairs are expensed as incurred. Expenditures to refurbish tanks that either extend the useful lives of the tanks or prevent environmental contamination are capitalized and depreciated over the remaining useful life of the tanks. Additionally, Heritage capitalizes certain costs directly related to the installation of company-owned tanks, including internal labor costs. Changes in the estimated useful lives of the Partnership's assets, or its' capitalization policy could have a material effect on the results of operations.

Intangibles and Other Assets. Intangibles and other assets are stated at cost net of amortization computed on the straight-line method. Heritage eliminates from its balance sheet any fully amortized intangibles and the related accumulated amortization. Changes in the amortization methods or asset values could have a material effect on results of operations.

Marketable Securities. Heritage's marketable securities are classified as available-for-sale securities and are reflected as a current asset on the consolidated balance sheet at their fair value. Unrealized holding losses are recorded through accumulated other comprehensive income (loss) based on the market value of the securities.

Long-Lived Assets. Heritage reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. If such a review should indicate that the carrying amount of long-lived assets is not recoverable, Heritage reduces the carrying amount of such assets to fair value.

Stock Based Compensation Plans. The Partnership accounts for its Restricted Unit Plan and Long-Term Incentive Plan using APB Opinion No. 25 Accounting for Stock Issued to Employees (APB 25). These plans are classified as variable plans so estimates of compensation are required based on a combination of the fair market value of the Common Units as of the end of the reporting period and the extent or degree of compliance with the performance criteria. Heritage follows the disclosure only provisions of SFAS 123, as amended by Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure (SFAS 148). Heritage adopted the fair value recognition provisions of SFAS 123 effective as of September 1, 2002.

Heritage adopted the fair value recognition provisions following the modified prospective method of adoption described in SFAS 123. Following adoption, deferred compensation expense that will be recognized will be the same as that which would have been recognized had the fair value recognition provisions of SFAS 123 been applied to all awards granted under the Restricted Unit Plan and the Long Term Incentive Plan granted its original effective date. Results from prior years have not been restated.

SFAS 133 Accounting for Derivative Instruments and Hedging Activities. In June 1998, the FASB issued Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133). SFAS 133 requires that all derivatives be recognized in the balance sheet as either an asset or liability measured at fair value. Special accounting for qualifying hedges allows a derivative's gains and losses to offset related results on the hedged item in the statement of operations.

LIQUIDS MARKETING ACTIVITIES

The Partnership buys and sells derivative financial instruments, which are within the scope of SFAS 133 and that are not designated as accounting hedges. The Partnership also enters into energy trading contracts, which are not derivatives, and therefore are not within the scope of SFAS 133. EITF Issue No. 98-10, Accounting for Contracts Involved in Energy Trading and Risk Management Activities (EITF 98-10), applied to energy trading contracts not within the scope of SFAS 133 that were entered into prior to October 25, 2002. The types of contracts the Partnership utilizes in its liquids marketing segment include energy commodity forward contracts, options, and swaps traded on the over-the-counter financial markets. In accordance with the provisions of SFAS 133, derivative financial instruments utilized in connection with the Partnership's liquids marketing activity are accounted for using the mark-to-market method. Additionally, all energy trading contracts entered into prior to October 25, 2002 were accounted for using the mark-to-market method in accordance with the provisions of EITF 98-10. Under the mark-to-market method of accounting, forwards, swaps, options, and storage contracts are reflected at fair value, and are shown in the consolidated balance sheet as assets and liabilities from liquids marketing activities. As of August 31, 2002, the Partnership adopted the applicable provisions of EITF Issue No. 02-3, Issues Related to Accounting for Contracts Involved in Energy Trading and Risk Management Activities (EITF 02-3), which requires that gains and losses on derivative instruments be shown net in the statement of operations if the derivative instruments are held for trading purposes. Net realized and unrealized gains and losses from the financial contracts and the impact of price movements are recognized in the statement of operations as liquids marketing revenue. Changes in the assets and liabilities from the liquids marketing activities result primarily from changes in the market prices, newly originated transactions, and the timing and settlement of contracts. EITF 02-3 also rescinds EITF 98-10 for all energy trading contracts entered into after October 25, 2002, and specifies certain disclosure requirements. Consequently, the Partnership does not apply mark-to-market accounting for any contracts entered into after October 25, 2002, that are not within the scope of SFAS 133. The Partnership attempts to balance its contractual portfolio in terms of notional amounts and timing of performance and delivery obligations. However, net unbalanced positions can exist or are established based on management's assessment of anticipated market movements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Heritage has little cash flow exposure due to interest rate changes for long-term debt obligations. Heritage had \$44.2 million of variable rate debt

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outstanding as of August 31, 2002. The variable rate debt consists of the Bank Credit Facility described elsewhere in this report. The balance in the Bank Credit Facility generally fluctuates throughout the year. A theoretical change of 1% in the interest rate on the balance outstanding at August 31, 2002 would result in an approximate \$442 thousand change in net income. Heritage primarily enters debt obligations to support general corporate purposes including capital expenditures and working capital needs. Heritage's long-term debt instruments are typically issued at fixed interest rates. When these debt obligations mature, Heritage may refinance all or a portion of such debt at then-existing market interest rates which may be more or less than the interest rates on the maturing debt.

Commodity price risk arises from the risk of price changes in the propane inventory that Heritage buys and sells. The market price of propane is often subject to volatile changes as a result of supply or other market conditions over which Heritage will have no control. In the past, price changes have generally been passed along to Heritage's and Predecessor Heritage's customers to maintain gross margins, mitigating the commodity price risk. In order to help ensure adequate supply sources are available to Heritage during periods of high demand, Heritage at times will purchase significant volumes of propane during periods of low demand, which generally occur during the summer months, at the then current market price, for storage both at its customer service locations and in major storage facilities and for future delivery.

Heritage also attempts to minimize the effects of market price fluctuations for its propane supply by entering into certain financial contracts. In order to manage a portion of its propane price market risk, Heritage uses contracts for the forward purchase of propane, propane fixed-price supply agreements, and derivative commodity

35

instruments such as price swap and option contracts. The swap instruments are a contractual agreement to exchange obligations of money between the buyer and seller of the instruments as propane volumes during the pricing period are purchased. The swaps are tied to a fixed price bid by the buyer and a floating price determination for the seller based on certain indices at the end of the relevant trading period. Heritage had entered into these swap instruments in the past to hedge the projected propane volumes to be purchased during each of the one-month periods during the projected heating season.

At August 31, 2002, Heritage had no outstanding propane hedges. Heritage continues to monitor propane prices and may enter into additional propane hedges in the future. Inherent in the portfolio from the liquids marketing activities of the Partnership is certain business risks, including market risk and credit risk. Market risk is the risk that the value of the portfolio will change, either favorably or unfavorably, in response to changing market conditions. Credit risk is the risk of loss from nonperformance by suppliers, customers, or financial counter parties to a contract. Heritage takes an active role in managing and controlling market and credit risk, and has established control procedures, which are reviewed on an ongoing basis. Heritage monitors market risk through a variety of techniques, including routine reporting to senior management. Heritage attempts to minimize credit risk exposure through credit policies and periodic monitoring procedures.

LIQUIDS MARKETING

Heritage buys and sells derivative financial instruments, which are within the scope of SFAS 133 and that are not designated as accounting hedges. Heritage also enters into energy trading contracts, which are not derivatives, and therefore are not within the scope of SFAS 133. EITF Issue No. 98-10, Accounting

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for Contracts Involved in Energy Trading and Risk Management Activities (EITF 98-10), applied to energy trading contracts not within the scope of SFAS 133 that were entered into prior to October 25, 2002. The types of contracts Heritage utilizes in its liquids marketing segment include energy commodity forward contracts, options, and swaps traded on the over-the-counter financial markets. In accordance with the provisions of SFAS 133, derivative financial instruments utilized in connection with Heritages' liquids marketing activity are accounted for using the mark-to-market method. Additionally, all energy trading contracts entered into prior to October 25, 2002 were accounted for using the mark-to-market method in accordance with the provisions of EITF 98-10. Under the mark-to-market method of accounting, forwards, swaps, options, and storage contracts are reflected at fair value, and are shown in the consolidated balance sheet as assets and liabilities from liquids marketing activities. As of August 31, 2002, Heritage adopted the applicable provisions of EITF Issue No. 02-3, Issues Related to Accounting for Contracts Involved in Energy Trading and Risk Management Activities (EITF 02-3), which requires that gains and losses on derivative instruments be shown net in the statement of operations if the derivative instruments are held for trading purposes. Net realized and unrealized gains and losses from the financial contracts and the impact of price movements are recognized in the statement of operations as liquids marketing revenue. Changes in the assets and liabilities from the liquids marketing activities result primarily from changes in the market prices, newly originated transactions, and the timing and settlement of contracts. EITF 02-3 also rescinds EITF 98-10 for all energy trading contracts entered into after October 25, 2002 and specifies certain disclosure requirements. Consequently, Heritage does not apply mark-to-market accounting for any contracts entered into after October 25, 2002 that are not within the scope of SFAS 133. Heritage attempts to balance its contractual portfolio in terms of notional amounts and timing of performance and delivery obligations. However, net unbalanced positions can exist or are established based on management's assessment of anticipated market movements.

The notional amounts and terms of these financial instruments as of August 31, 2002 and 2001 include fixed price payor for 1,180,000 and 2,130,000 barrels of propane, respectively, and fixed price receiver of 1,076,900 and 1,820,000 barrels of propane, respectively. Notional amounts reflect the volume of the transactions, but do not represent the amounts exchanged by the parties to the financial instruments. Accordingly, notional amounts do not accurately measure Heritage's exposure to market or credit risks.

The fair value of the financial instruments related to liquids marketing activities as of August 31, 2002 and 2001 was assets of \$2.3 million and \$6.5 million, respectively, and liabilities of \$1.8 million and \$7.1 million, respectively.

36

SENSITIVITY ANALYSIS

Estimates related to Heritage's liquids marketing activities are sensitive to uncertainty and volatility inherent in the energy commodities markets and actual results could differ from these estimates. A theoretical change of 10% in the underlying commodity value of the liquids marketing contracts would result in an approximate \$181 thousand change in the market value of the contracts as there were approximately 4.3 million gallons of net unbalanced positions at August 31, 2002.

DISCLOSURES ABOUT LIQUIDS MARKETING ACTIVITIES ACCOUNTED FOR AT FAIR VALUE

The following table summarizes the fair value of Heritage's contracts, aggregated by method of estimating fair value of the contracts as of August 31,

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2002 and 2001 where settlement had not yet occurred. Resources' contracts all have a maturity of less than 1 year. The market prices used to value these transactions reflect management's best estimate considering various factors including closing average spot prices for the current and outer months plus a differential to consider time value and storage costs.

| Source of Fair Value | August 31, 2002 ----- | August 31, 2001 ----- |
|---|-----------------------------|-----------------------------|
| Prices actively quoted | \$ 1,276 | \$ 827 |
| Prices based on other valuation methods | 1,025 | 5,638 |
| | ----- | ----- |
| Assets from liquids marketing | \$ 2,301 | \$ 6,465 |
| | ===== | ===== |
| Prices actively quoted | \$ 669 | \$ 1,297 |
| Prices based on other valuation methods | 1,149 | 5,833 |
| | ----- | ----- |
| Liabilities from liquids marketing | \$ 1,818 | \$ 7,130 |
| | ===== | ===== |
| Unrealized gains (losses) | \$ 483 | \$ (665) |
| | ===== | ===== |

The following table summarizes the changes in the unrealized fair value of Heritage's contracts where settlement had not yet occurred for the fiscal years ended August 31, 2002 and 2001 and the 8-months ended August 31, 2000.

| | 2002 ----- | 2001 ----- |
|---|---------------|---------------|
| Unrealized gains (losses) in fair value of contracts outstanding at the beginning of the period | \$ (665) | \$ 59 |
| Unrealized gains (losses) recognized at inception of contracts | -- | -- |
| Unrealized gains (losses) recognized as a result of changes in valuation techniques and assumptions | -- | -- |
| Other unrealized gains (losses) recognized during the period | 1,207 | 25 |
| Less: Realized gains (losses) recognized during the period | 59 | 1,50 |
| | ----- | ----- |
| Unrealized gains (losses) in fair value of contracts outstanding at the end of the period | \$ 483 | \$ (66) |
| | ===== | ===== |

37

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

The Financial statements set forth on pages F-1 to F-47 of this report are incorporated herein by reference.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

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None.

38

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

PARTNERSHIP MANAGEMENT

The Partnership does not directly employ any persons responsible for its management or operations. Prior to the February 4, 2002 Special Meeting of the Common Unitholders of the Partnership, all of the Partnership's activities were managed and operated by its General Partner, Heritage Holdings. Persons employed to manage and operate the activities of the Partnership and its subsidiaries were employees, officers or directors of Heritage Holdings.

Following Common Unitholder approval of the substitution of U.S. Propane as General Partner of the Partnership, the Partnership's activities have been managed and operated by U.S. Propane. Former employees of Heritage Holdings became employees of U.S. Propane. Officers and directors of Heritage Holdings were appointed officers and directors of U.S. Propane's General Partner, USPLLC. Each of the thirteen members of the Board of Directors of Heritage Holdings was appointed, individually, a manager of USPLLC, and collectively, such persons are referred to as the Board of Directors. The Board of Directors of USPLLC is comprised of its Chairman, its President and Chief Executive Officer, two persons designated by each of its four members, and three independent persons approved by a majority of the members.

The Board of Directors appoints members of the Board to serve on the Independent Committee with the authority to review specific matters to which the Board of Directors believes there may be a conflict of interest in order to determine if the resolution of such conflict proposed by the General Partner is fair and reasonable to the Partnership. Any matters approved by the Independent Committee will be conclusively deemed to be fair and reasonable to the Partnership, approved by all partners of the Partnership and not a breach by the General Partner or its Board of Directors of any duties they may owe the Partnership or the Unitholders. Bill W. Byrne, Stephen L. Cropper, and J. Charles Sawyer were appointed to serve as the members of the Independent Committee of the Board of Directors of Heritage Holdings in October of 2001, appointed as members of the Independent Committee of the Board of Directors of USPLLC on February 4, 2002, and reappointed in October 2002.

AUDIT COMMITTEE

The Board of Directors appoints persons who are neither officers of USPLLC nor employees of the General Partner or any affiliate of the Partnership to serve on its Audit Committee. The Audit Committee has at least one person with accounting or financial management expertise. The Audit Committee meets on a scheduled basis with the Partnership's independent accountants and is available to meet at their request. The Audit Committee has the authority and responsibility to review external financial reporting of the Partnership, to review the Partnership's procedures for internal auditing and the adequacy of the Partnership's internal accounting controls, to consider the qualifications and independence of the Partnership's independent accountants, to engage the Partnership's independent accountants, and to review the letter of engagement and statement of fees relating to the scope of the annual audit work and special audit work which may be recommended or required by the independent accountants. The Audit Committee reviews and discusses the audited financial statements with management, discusses with the Partnership's independent auditors matters required to be discussed by SAS 61, Communications with Audit Committees, and

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makes recommendations to the Board of Directors relating to the Partnership's audited financial statements. On February 4, 2002, the Board of Directors of USPLLC adopted the Charter for the Audit Committee previously adopted by Heritage Holdings. Any matters approved by the Audit Committee will be conclusively deemed to be fair and reasonable to the Partnership, approved by all partners of the Partnership and not a breach by the General Partner or its Board of Directors of any duties they may owe the Partnership or the Unitholders. Bill W. Byrne, Stephen L. Cropper, and J. Charles Sawyer were appointed to serve as members of the Audit Committee of the Board of Directors of Heritage Holdings in October of 2001, appointed as members of the Audit Committee of the Board of Directors of USPLLC on February 4, 2002, and reappointed in October 2002.

39

EMPLOYEE MATTERS

The Partnership does not directly employ any of the persons responsible for managing or operating the Partnership. As of August 31, 2002, the General Partner or subsidiaries of the Partnership employed 2,265 full time individuals. The employment agreements with Messrs. Bertelsmeyer and Krimbill specify that they serve as Chairman of the Board and President and Chief Executive Officer, respectively.

DIRECTORS AND EXECUTIVE OFFICERS OF THE GENERAL PARTNER

The following table sets forth certain information with respect to the executive officers and members of the Board of Directors as of October 31, 2002. Executive officers and directors are elected for one-year terms.

| Name ---- | Age --- | Position with General Partner ----- |
|-------------------------|------------|--|
| H. Michael Krimbill (1) | 49 | President and Chief Executive Officer, and Director |
| James E. Bertelsmeyer | 60 | Chairman of the Board and Director |
| R. C. Mills | 65 | Executive Vice President and Chief Operating Officer |
| Michael L Greenwood (2) | 47 | Vice President, Chief Financial Officer, Secretary & Treasurer |
| Bradley K. Atkinson | 47 | Vice President of Corporate Development |
| Mark A. Darr (3) | 42 | Vice President - Southern Operations |
| Thomas H. Rose (3) | 58 | Vice President - Northern Operations |
| Curtis L. Weishahn (3) | 49 | Vice President - Western Operations |
| Bill W. Byrne | 72 | Director of the General Partner |
| J. Charles Sawyer | 66 | Director of the General Partner |
| Stephen L. Cropper (4) | 52 | Director of the General Partner |
| J. Patrick Reddy (1) | 49 | Director of the General Partner |
| Royston K. Eustace (1) | 61 | Director of the General Partner |

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| | | |
|-------------------------|----|---------------------------------|
| William N. Cantrell (1) | 50 | Director of the General Partner |
| Clayton H. Preble (5) | 55 | Director of the General Partner |
| David J. Dzuricky (1) | 51 | Director of the General Partner |
| JD Woodward III (6) | 52 | Director of the General Partner |
| Richard T. O'Brien (6) | 48 | Director of the General Partner |
| Kevin M. O'Hara (7) | 44 | Director of the General Partner |
| Andrew W. Evans (8) | 36 | Director of the General Partner |

- (1) Elected to the Board of Directors August 2000.
- (2) Elected Vice President and Chief Financial Officer July 2002.
- (3) Elected an Executive Officer July 2000.
- (4) Elected to the Board of Directors April 2000

40

- (5) Elected to the Board of Directors August 2000 and resigned October 2002.
- (6) Elected to the Board of Directors October 2001
- (7) Elected to the Board of Directors April 2002
- (8) Elected to the Board of Directors October 2002.

H. Michael Krimbill. Mr. Krimbill joined Heritage as Vice President and Chief Financial Officer in 1990 and was previously Treasurer of a publicly traded, fully integrated oil company. Mr. Krimbill was promoted to President of Heritage in April 1999 and to Chief Executive Officer in March 2000. Mr. Krimbill is a director of the National Propane Gas Association, (the "NPGA").

James E. Bertelsmeyer. Mr. Bertelsmeyer has over 25 years of experience in the propane industry, including six years as President of Buckeye Gas Products Company, at the time the nation's largest retail propane marketer. Mr. Bertelsmeyer served as Chief Executive Officer of Heritage since its formation until the election of H. Michael Krimbill in March 2000. Mr. Bertelsmeyer began his career with Conoco Inc. where he spent ten years in positions of increasing responsibility in the pipeline and gas products departments. Mr. Bertelsmeyer has been a director of the NPGA for the past 25 years, and is a former president of the NPGA.

R. C. Mills. Mr. Mills has over 40 years of experience in the propane industry. Mr. Mills joined Heritage in 1991 as Executive Vice President and Chief Operating Officer. Before coming to Heritage, Mr. Mills spent 25 years with Texgas Corporation and its successor, Suburban Propane, Inc. At the time he left Suburban in 1991, Mr. Mills was Vice President of Supply and Wholesale.

Michael L. Greenwood. Mr. Greenwood became Heritage's Vice President, Chief Financial Officer, Secretary and Treasurer on July 1, 2002. Prior to joining Heritage, Mr. Greenwood was Senior Vice President, Chief Financial Officer and Treasurer for Alliance Resource Partners, L.P., a publicly traded master limited partnership involved in the production and marketing of coal. Mr. Greenwood brings to Heritage over 20 years of diverse financial and management

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experience in the energy industry during his career with several major public energy companies including MAPCO Inc., Penn Central Corporation, and The Williams Companies.

Bradley K. Atkinson. Mr. Atkinson joined Heritage on April 16, 1998 as Vice President of Administration. Prior to joining Heritage, Mr. Atkinson spent twelve years with MAPCO/Thermogas, eight of which were spent in the acquisitions and business development of Thermogas. Mr. Atkinson was promoted to Vice President of Corporate Development in August 2000.

Mark A. Darr. Mr. Darr has 17 years in the propane industry. Mr. Darr joined Heritage in 1991 and has held various positions including District Manager and Vice President and Regional Manager before his election to Vice President - Southern Operations, in July 2000. Prior to joining Heritage, Mr. Darr held various positions with Texgas Corporation, and its successor, Suburban Propane. He is a past President of the Florida Propane Gas Association, the Florida Director of the NPGA, and a member of the LP Gas Bureau State Advisory Council

Thomas H. Rose. Mr. Rose has 26 years of experience in the propane industry. Mr. Rose joined Heritage in November 1994 as Vice President and Regional Manager. Prior to joining Heritage, Mr. Rose held Regional Manager positions with Texgas Corporation, its successor, Suburban Propane, and later Vision Energy of Florida. Mr. Rose was appointed Vice President - Northern Operations in July 2000.

Curtis L. Weishahn. Mr. Weishahn has 24 years experience in the propane industry. Mr. Weishahn joined Heritage in 1995 as Vice President and Regional Manager and was elected Vice President - Western Operations in July 2000. Prior to joining Heritage, Mr. Weishahn owned his own propane business, which was acquired by Heritage. Prior to that time, Mr. Weishahn spent twelve years with Amerigas/CalGas where, at the time of departing, he was Director of Marketing/Strategic Development for the Western United States.

Bill W. Byrne. Mr. Byrne is the principal of Byrne & Associates, LLC, a gas liquids consulting group based in Tulsa, Oklahoma, and has held that position since 1992. Prior to that time, he served as Vice President of Warren Petroleum Company, the gas liquids division of Chevron Corporation, from 1982-1992. Mr. Byrne has served as a director of Heritage since 1992, is a member of both the Independent Committee and the Compensation Committee, and is Chairman of the Audit Committee. Mr. Byrne is a former president and director of the NPGA.

41

J. Charles Sawyer. Mr. Sawyer is the President and Chief Executive Officer of Computer Energy, Inc., a provider of computer software to the propane industry since 1981. Mr. Sawyer is also the President and Chief Executive Officer of Sawyer Cellars. Mr. Sawyer was Chief Executive Officer of Sawyer Gas Co., a regional propane distributor, until it was purchased by Heritage in 1991. Mr. Sawyer has served as a director of Heritage since 1991 and is a member of both the Independent Committee and the Audit Committee. Mr. Sawyer is a former president and director of the NPGA.

Stephen L. Cropper. Mr. Cropper spent 25 years with The Williams Companies before retiring in 1998, as President and Chief Executive Officer of Williams Energy Services. Mr. Cropper is a director of Rental Car Finance Corp. and Berry Petroleum. He also serves as a director and member of the compensation committees of Sun Logistics and QuikTrip Corporation. Mr. Cropper has served as a director of Heritage since April 2000 and is a member of the both the Independent Committee and the Audit Committee.

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J. Patrick Reddy. Mr. Reddy is the Senior Vice President and Chief Financial Officer of Atmos Energy and has held that position since October 2000. Prior to being named to that position, Mr. Reddy served as Atmos Energy's Senior Vice President, Chief Financial Officer and Treasurer from March 2000 to September 2000, and its Vice President of Corporate Development and Treasurer during the period from December 1998 to April 2000. Prior to joining Atmos Energy in August 1998 as Vice President, Corporate Development, Mr. Reddy held a number of management positions with Pacific Enterprises, Inc. during the period from 1980 to 1998, including Vice President, Planning & Advisory Services from 1995 to August 1998. Mr. Reddy has served as a director of Heritage since August 2000 and is a member of the Compensation Committee.

Royston K. Eustace. Mr. Eustace is the Senior Vice President of Business Development for TECO, and has held that position since 1998. Mr. Eustace has also served as the President of TECO Coalbed Methane since 1991 and as the President of TECO Oil & Gas since 1995. Mr. Eustace joined TECO in 1987 as its Vice President of Strategic Planning and Business Development. Mr. Eustace has served as a director of Heritage since August 2000 and is Chairman of the Compensation Committee.

William N. Cantrell. Mr. Cantrell currently serves as President of several TECO companies engaged in natural gas distribution, gas marketing, and energy services, including Peoples Gas System, TECO Solutions and TECO Partners, Inc. Mr. Cantrell has been employed with TECO since 1975. At the time of the formation of U.S. Propane, Mr. Cantrell was the President of Peoples Gas Company, a regional propane distributor serving the Florida market. Mr. Cantrell has served as a director of Heritage since August 2000.

Clayton H. Preble. Mr. Preble is the Senior Vice President of AGL Resources, Inc. ("AGL") and has held that position since June 1999. Prior to being named to that position, Mr. Preble served as the Senior Vice President - Direct Marketing of SouthStar Energy Services, L.L.C. and as the President of The Energy Spring, Inc., both affiliates of AGL. Mr. Preble joined AGL in 1970 and served in various executive capacities prior to these positions. Mr. Preble served as a director of Heritage from August 2000 until his resignation in October 2002.

David J. Dzuricky. Mr. Dzuricky is the Senior Vice President and Chief Financial Officer of Piedmont Natural Gas and has served in that capacity since May 1995. Prior to being named to that position, Mr. Dzuricky held a variety of executive officer positions with Consolidated Natural Gas Company during the period from 1982 to 1995. Mr. Dzuricky has served as a director of Heritage since August 2000.

JD Woodward III. Mr. Woodward has served as Senior Vice President of Non Utility Operations of Atmos Energy since April 2001, and is responsible for Atmos Energy's non-regulated business activities. Prior to being named to that position, Mr. Woodward held the position of President of Woodward Marketing, LLC, in Houston, Texas from January 1995 to March 2001. Mr. Woodward was named a director of Heritage in October 2001.

Richard T. O'Brien. Mr. O'Brien is Executive Vice President and Chief Financial Officer of AGL Resources and has held that position since May 2001. Prior to being named to that position, he was Vice President of Mirant (formerly Southern Energy) and President of Mirant Capital Management, LLC from March 2000 to April 2001 in Atlanta, Georgia. Prior to that time, Mr. O'Brien held various executive positions with PacifiCorp in Portland, Oregon during the period from 1983 to 2000. Mr. O'Brien was named a director of Heritage October 2001.

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Kevin M. O'Hara. Mr. O'Hara is Vice President of Corporate Planning for Charlotte-based Piedmont Natural Gas. Mr. O'Hara joined Piedmont Natural Gas in 1987 and his current responsibilities include the development and implementation of corporate strategies related to system expansion and organization development. In addition, Mr. O'Hara has responsibility for non-regulated business activities of Piedmont Natural Gas. His prior work experience was with Andersen Consulting (now Accenture) where he started his career in their Chicago office. Mr. O'Hara was elected a director of Heritage in April 2002.

Andrew W. Evans. Mr. Evans is the Vice President of Finance and Treasurer of AGL Resources. He has held that position since May 2002. Prior thereto Mr. Evans was with Mirant Corporation where he served as Vice President of Corporate Development for Mirant Americas business unit, and prior to that Vice President and Treasurer for Mirant Americas. During his tenure with Mirant, he oversaw market analysis and structured product development for the energy marketing business. He also served as Director of Finance for Mirant's trading business, Mirant Americas Energy Marketing. Prior to Mirant, Evans was employed by the Cambridge, MA office of National Economic Research Associates and the Federal Reserve Bank of Boston. Mr. Evans was named a director of Heritage in October 2002.

COMPENSATION OF THE GENERAL PARTNER

The General Partner does not receive any management fee or other compensation in connection with its management of the Partnership and the Operating Partnership. The General Partner and its affiliates performing services for the Partnership and the Operating Partnership are reimbursed at cost for all expenses incurred on behalf of Heritage, including the costs of compensation allocable to Heritage, and all other expenses necessary or appropriate to the conduct of the business of, and allocable to, Heritage. These costs totaled approximately \$95.7 million for the year ended August 31, 2002 and \$93.4 million for the year ended August 31, 2001.

COMPLIANCE WITH SECTION 16(A) OF THE SECURITIES AND EXCHANGE ACT

Section 16(a) of the Securities and Exchange Act of 1934 requires the Partnership's officers and directors, and persons who own more than 10% of a registered class of the Partnership's equity securities, to file reports of beneficial ownership and changes in beneficial ownership with the Securities and Exchange Commission ("SEC"). Officers, directors and greater than 10% Unitholders are required by SEC regulations to furnish the General Partner with copies of all Section 16(a) forms.

Based solely on the Partnership's review of the copies of such forms received by it, or written representations from certain reporting persons that no Form 5s were required for those persons, the Partnership believes that during fiscal year ending August 31, 2002, all filing requirements applicable to its officers, directors, and greater than 10% beneficial owners were met in a timely manner.

ITEM 11. EXECUTIVE COMPENSATION.

The following table sets forth the annual salary, bonus and all other compensation awards and payouts for each of the past three fiscal years earned by: (i) all persons serving as the Chief Executive Officer of the General Partner of the Partnership during fiscal year 2002; (ii) the four next highly compensated executive officers other than the Chief Executive Officer, who served as executive officers of the General Partner of the Partnership during fiscal year 2002 and (iii) any persons who would have been reported had they been an executive officer of the General Partner of the Partnership at the end of fiscal year 2002.

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43

| Name and Principal Position ----- | Year ---- | Salary ----- | Bonus (1) --- | Other Annual Compensation (2) --- |
|--------------------------------------|--------------|-----------------|---------------------|--|
| James E. Bertelsmeyer | 2002 | \$193,500 | \$ -- | \$ 501 |
| Chairman of the Board | 2001 | 193,500 | -- | 400 |
| | 2000 | 387,297 | -- | 695 |
| H. Michael Krimbill | 2002 | \$350,000 | \$350,000 | \$ 242 |
| President and Chief | 2001 | 350,000 | 280,000 | 242 |
| Executive Officer | 2000 | 251,678 | -- | 193 |
| R. C. Mills | 2002 | \$335,000 | \$350,000 | \$ 1,700 |
| Executive Vice President | 2001 | 335,000 | 280,000 | 1,066 |
| and Chief Operating Officer | 2000 | 244,732 | -- | 822 |
| Michael L. Greenwood (4) | 2002 | \$240,000 | \$ -- | \$ -- |
| Vice President and | 2001 | -- | -- | -- |
| Chief Financial Officer | 2000 | -- | -- | -- |
| Larry J. Dagley (5) | 2002 | \$325,000 | \$350,000 | \$ 372 |
| Vice President and | 2001 | 325,000 | 280,000 | 372 |
| Chief Financial Officer | 2000 | -- | -- | -- |
| Bradley K. Atkinson | 2002 | \$220,000 | \$410,944 | \$ 158 |
| Vice President - | 2001 | 200,000 | 280,000 | 145 |
| Corporate Development | 2000 | 134,836 | 125,000 | 72 |

- (1) Bonuses are earned based on the results of operations for each fiscal year. The payment in any one fiscal year is limited and the excess bonus earned is deferred until the next fiscal year.
- (2) Consists of life insurance premiums.
- (3) Consists of the value of Common Units issued pursuant to the vesting rights of the Restricted Unit Plan.
- (4) Mr. Greenwood was named Chief Financial Officer in July of 2002. Mr. Greenwood's 2002 salary was annualized.
- (5) Mr. Dagley resigned from the position of Chief Financial Officer as of June 30, 2002.

EMPLOYMENT AGREEMENTS

The General Partner has entered into employment agreements (the "Employment Agreements") with Messrs. Bertelsmeyer, Krimbill, Mills, Atkinson, Weishahn, Rose, and Darr. The summary of such Employment Agreements contained herein does not purport to be complete and is qualified in its entirety by reference to the Employment Agreements, which have been filed previously as exhibits.

The Employment Agreement for Mr. Bertelsmeyer had an initial term of two years starting August 2000, with an annual base salary of \$193,500. At the

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expiration of the term on August 10, 2002, Mr. Bertelsmeyer's employment agreement became "at will." The Employment Agreements for Messrs. Krimbill, Mills, Atkinson, Weishahn, Rose, and Darr (each an "Executive") have an initial term of three years starting August 2000. However, for each Executive with the three year Employment Agreement, beginning on the second anniversary of the effective date and on each day thereafter the expiration date shall be automatically extended one additional day unless either party (i) shall give written notice to the other that the Term shall cease to be so extended beginning immediately after the date of such notice or (ii) shall give a Notice of Termination to the other by delivering notice to the Chairman of the Board, or in the event of the Executive's death. The Employment Agreements for each of Messrs, Krimbill, Mills, Atkinson, Weishahn, Rose, and Darr, provide for an annual base salary of \$350,000, \$335,000, \$200,000, \$150,000, \$135,000, and \$135,000, respectively. The Board shall review the Base Salary at least annually and may

44

adjust the amount of the Base Salary at any time, as the Board may deem appropriate in its sole discretion; provided, however, that in no event may the Base Salary be decreased below the above stated amount without the prior written consent of the employee. The Employment Agreements provide for the Executives to participate in bonus and incentive plans. The Employment Agreements also provide for the Executive and, where applicable, the Executive's dependents, to have the right to participate in benefit plans made available to other executives of Heritage including the Restricted Unit Plan and the Long-Term Incentive Plan described below.

The Employment Agreements provide that in the event of a change of control of the ownership of the General Partner or in the event an Executive (i) is involuntarily terminated (other than for "misconduct" or "disability") or (ii) voluntarily terminates employment for "good reason" (as defined in the agreements), such Executive will be entitled to continue receiving his base salary and to participate in all group health insurance plans and programs that may be offered to executives of the General Partner for the remainder of the term of the Employment Agreement or, if earlier, the Executive's death, and the Executive will vest immediately in the Minimum Award of the number of Common Units to which the Executive is entitled under the Long Term Incentive Plan to the extent not previously awarded, and if the executive is terminated as a result of the foregoing, all restrictions on the transferability of the units purchased by such executive under the Subscription Agreement dated as of June 15, 2000, previously filed as an exhibit, shall automatically lapse in full on such date. Each Employment Agreement also provides that if any payment received by an Executive is subject to the 20% federal excise tax under Section 4999(a) of the Code of the Internal Revenue Service, the Payment will be grossed up to permit the Executive to retain a net amount on an after-tax basis equal to what he would have received had the excise tax and all other federal and state taxes on such additional amount not been payable. In addition, each Employment Agreement contains non-competition and confidentiality provisions.

RESTRICTED UNIT PLAN

The Partnership adopted the Amended and Restated Restricted Unit Plan dated August 10, 2000, amended February 4, 2002 as the Second Amended and Restated Restricted Unit Plan. (the "Restricted Unit Plan"), previously filed as exhibits, for certain directors and key employees of the General Partner and its affiliates. The Restricted Unit Plan covers rights to acquire 146,000 Common Units. The right to acquire the Common Units under the Restricted Unit Plan, including any forfeiture or lapse of rights are available for grant to key employees on such terms and conditions (including vesting conditions) as the Compensation Committee of the General Partner shall determine. Each director

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shall automatically receive a Director's grant with respect to 500 Common Units on each September 1 that such person continues as a director. Newly elected directors are also entitled to receive a grant with respect to 2,000 Common Units upon election or appointment to the Board. Directors who are employees of U.S. Propane, TECO, Atmos Energy, Piedmont Natural Gas or AGL Resources or their affiliates are not entitled to receive a Director's grant of Common Units. Messrs. Bertelsmeyer and Krimbill are not entitled to receive a Director's Grant of Common Units but may receive Common Units as employees. Generally, the rights to acquire the Common Units granted will vest upon the occurrence of specified performance objectives established by the Compensation Committee at the time designations of grants are made, or if later, the three-year anniversary of the grant date. In the event of a "change of control" (as defined in the Restricted Unit Plan), all rights to acquire Common Units pursuant to the Restricted Unit Plan will immediately vest.

Common Units to be delivered upon the "vesting" of rights may be Common Units acquired by the Partnership in the open market, Common Units already owned by the General Partner, Common Units acquired by the General Partner directly from the Partnership or any other person, or any combination of the foregoing. Although the Restricted Unit Plan permits the grant of distribution equivalent rights to key employees, it is anticipated that until such Common Units have been delivered to a participant, such participant shall not be entitled to any distributions or allocations of income or loss and shall not have any voting or other rights in respect of such Common Units. The General Partner will be entitled to reimbursement by the Partnership for the cost incurred in acquiring such Common Units.

The Board of Directors, in its discretion may terminate the Restricted Unit Plan at any time with respect to any Common Units for which a grant has not therefore been made. The Board will also have the right to alter or amend the Restricted Unit Plan or any part thereof from time to time; provided, however, that no change in any Restricted Unit may be made that would impair the rights of the participant without the consent of such participant.

45

The issuance of the Common Units pursuant to the Restricted Unit Plan is intended to serve as a means of incentive compensation for performance and not primarily as an opportunity to participate in the equity appreciation in respect of the Common Units. Therefore, no consideration will be payable by the plan participants upon vesting and issuance of the Common Units. As of August 31, 2002, 26,900 restricted units granted to non-employee directors and key employees were outstanding. Compensation expense of \$0.4 million and \$0.3 million was recognized for fiscal year 2002 and fiscal year 2001, respectively. See Note 6 -- "Partners' Capital" to the Consolidated Financial Statements, beginning on page F-1 of this report. Compensation expense of \$0.3 million was recognized in Predecessor Heritage's financial statements for the period ended August 9, 2000 and \$0.3 million for fiscal year 1999. See Note 5 -- "Partners' Capital" of Predecessor Heritage's Consolidated Financial Statements beginning on page F-37 of this report.

No grants of Common Units to persons serving as executive officers of the Partnership were made in the last fiscal year. At the time of his resignation as an executive officer, 10,000 Common Units were issued to Larry J. Dagley, the proportionate share of the maximum 15,000 units he would have been entitled to receive under the Restricted Unit Plan.

LONG-TERM INCENTIVE PLAN

Effective September 1, 2000, the Partnership adopted a long-term incentive plan whereby units will be awarded to the Executive Officers and other employees

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at its discretion based on achieving certain targeted levels of Distributed Cash (as defined in the Long Term Incentive Plan) per unit. Awards under the program will be made starting in 2003 based upon the average of the prior three years Distributed Cash per unit. A minimum of 250,000 units and if targeted levels are achieved, a maximum of 500,000 units will be awarded under the Long Term Incentive Plan. Compensation expense of \$1.5 and \$0.8 million was recognized for fiscal years 2002 and 2001, respectively.

COMPENSATION OF DIRECTORS

The Partnership currently pays no additional remuneration to its employees for serving as directors of the General Partner. Under the Restricted Unit Plan, directors other than directors who are employees of U.S. Propane, Atmos Energy, AGL Resources, TECO and Piedmont Natural Gas, or their affiliates, will be awarded 500 of these restricted units annually, and newly elected directors receive an initial award of 2,000 restricted units. The General Partner will pay each of its non-employee and nonaffiliated directors \$10,000 annually, plus \$1,000 per board meeting attended and \$500 per committee meeting attended. Each of the members of the Independent Committee received a payment of \$10,000 during fiscal year 2002, as payment for services and expenses rendered in conjunction with the Partnership's evaluation of potential acquisition candidates. All expenses associated with compensation of directors will be reimbursed to the General Partner by the Partnership.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

The Compensation Committee of the Board of Directors determines compensation of the executive officers. Royston K. Eustace, Bill W. Byrne, and J. Patrick Reddy served as members of the Compensation Committee of the Board of Directors of Heritage Holdings and as members of the Compensation Committee of the Board of Directors of USPLLC beginning February 4, 2002.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information as of October 31, 2002, regarding the beneficial ownership of the Partnership's securities by certain beneficial owners and all directors and named executive officers, both individually and as a group. The General Partner knows of no other person not disclosed herein beneficially owning more than 5% of the Partnership's Common Units.

46

HERITAGE PROPANE PARTNERS, L.P. UNITS

| Title of Class ----- | Name and Address (1) of Beneficial Owner ----- | Beneficially Owned (2) ----- |
|-------------------------|--|------------------------------------|
| Common Units | James E. Bertelsmeyer (3) | 1,104,397 |
| | H. Michael Krimbill (3) | 322,559 |
| | R.C. Mills (3) | 328,009 |
| | Michael L. Greenwood | 10,000 |
| | Larry J. Dagley (7) | 16,000 |
| | Bradley K. Atkinson | 13,600 |
| | Bill W. Byrne | 77,657 |
| | J. Charles Sawyer | 68,157 |
| | Stephen L. Cropper | 5,000 |
| | J. Patrick Reddy | - |

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| | |
|---|-----------|
| Royston K. Eustace | - |
| William N. Cantrell | - |
| Ware F. Schiefer (4) | - |
| David J. Dzuricky | - |
| Clayton H. Preble (4) | - |
| J.D. Woodward | - |
| Richard T. O'Brien | - |
| Kevin M. O'Hara (4) | - |
| Andrew W. Evans (4) | - |
| All Directors and Executive Officers as a group (20 persons) | 2,018,494 |
| Heritage Holdings, Inc. (5) | 4,426,916 |
| U.S. Propane L.P. (5) (6) | 4,639,636 |
| U.S. Propane, L.L.C. (5) (6) | 4,639,636 |

* Less than one percent (1%)

- (1) The address for Mr. Krimbill, Mr. Greenwood, and Mr. Atkinson is 8801 S. Yale, Suite 310, Tulsa, Oklahoma 74137. The address for U.S. Propane, L.P. is 702 N. Franklin Street, Tampa, Florida 33602. The address for each of Messrs. Bertelsmeyer, and Mills is 5000 Sawgrass Village Circle, Suite 4, Ponte Vedra Beach, Florida 32082. The address for Heritage Holdings is c/o Brett Stovern, AGL Resources, Inc., 817 W. Peachtree St., Atlanta, Georgia 30308.
- (2) Beneficial ownership for the purposes of the foregoing table is defined by Rule 13d-3 under the Securities Exchange Act of 1934. Under that rule, a person is generally considered to be the beneficial owner of a security if he has or shares the power to vote or direct the voting thereof ("Voting Power") or to dispose or direct the disposition thereof ("Investment Power") or has the right to acquire either of those powers within sixty (60) days.
- (3) Each of Messrs. Bertelsmeyer, Byrne, Mills, and Krimbill shares Voting and Investment Power on a portion of their respective units with his spouse.
- (4) Mr. O'Hara replaced Mr. Schiefer effective April 24, 2002, and Mr. Evans replaced Mr. Preble on the Board of Directors effective October 1, 2002.
- (5) U.S. Propane, L.P. owns 212,720 Common Units and, by virtue of its ownership of 100% of Heritage Holdings, may be deemed to beneficially own the 4,426,916 Common Units owned by Heritage Holdings. U.S. Propane L.L.C., as the general partner of U.S. Propane, L.P., may be deemed to beneficially own the 212,720 Common Units owned by U.S. Propane, L.P. and the 4,426,916 Common Units owned by Heritage Holdings. U.S. Propane, L.P. disclaims any beneficial ownership with respect to the Common Units owned by Heritage Holdings and U.S. Propane L.L.C. disclaims any beneficial ownership with respect to the Common Units owned by U.S. Propane, L.P. and Heritage Holdings.

47

- (6) U.S. Propane, L.P. owns 100% of the common stock of Heritage Holdings. AGL Propane Services, Inc., United Cities Propane Gas, Inc., TECO Propane Ventures, LLC and Piedmont Propane Company own a 22.358%, 18.968%, 37.976% and 20.688%, respectively, limited partner interest in U.S. Propane, L.P. U.S. Propane, L.L.C. is the General Partner of U.S. Propane, L.P. with a 0.01% general partner interest. The members of U.S. Propane L.L.C. and their respective membership interest is as follows:

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| | |
|---------------------------------|--------|
| AGL Energy Corporation | 22.36% |
| United Cities Propane Gas, Inc. | 18.97% |
| TECO Propane Ventures, LLC | 37.98% |
| Piedmont Propane Company | 20.69% |

- (7) Mr. Dagley was not an executive officer as of August 31, 2002, having resigned as such in June of 2002.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Computer Energy, Inc., ("Computer Energy") is a provider of computer software to the propane industry. During fiscal year 2002, purchases of computer software and/or additional licenses from Computer Energy were made by and utilized in Heritage's propane operations. The total amount of purchases made by Heritage in fiscal year 2002 did not exceed \$30,000, and were made under terms no less favorable than those available from other computer software providers. J. Charles Sawyer is the President and owner of 50% of the stock of Computer Energy. The Board of Directors has determined that Mr. Sawyer's stock ownership of Computer Energy and its relationship as a supplier of computer software to Heritage is not significant and does not affect his independence as a director of the General Partner of the Partnership.

Heritage has entered into an agreement with TECO Partners, Inc. ("TECO Partners") whereby TECO Partners will provide services relating to the securing of new propane customers in Heritage's Florida regional operations area. Under the agreement, TECO Partners receives commissions upon the procuring of new propane customers for Heritage. The terms of the agreement are no less favorable to Heritage than those available from other parties providing similar services. During fiscal year 2002, TECO Partners received commissions of less than \$180,000.

48

PART IV

ITEM 14. CONTROLS AND PROCEDURES

The Partnership maintains controls and procedures designed to ensure that information required to be disclosed in the reports that the Partnership files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC. Within 90 days prior to the filing date of this report, an evaluation was performed under the supervision and with the participation of the Partnership's management, including the Chief Executive Officer and the Chief Financial Officer of the General Partner of the Partnership, of the effectiveness of the design and operation of the Partnership's disclosure controls and procedures. Based upon that evaluation, management, including the Chief Executive Officer and the Chief Financial Officer of the General Partner of the Partnership, concluded that the Partnership's disclosure controls and procedures were adequate and effective as of August 31, 2002. No significant changes in the Partnership's internal controls or in other factors have occurred that could significantly affect controls subsequent to August 31, 2002.

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORT OF FORM 8-K.

- (A) 1. FINANCIAL STATEMENTS.

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See "Index to Financial Statements" set forth on page F-1.

2. FINANCIAL STATEMENT SCHEDULES.

None.

3. EXHIBITS.

See "Index to Exhibits" set forth on page E-1.

(B) REPORTS ON FORM 8-K.

The Registrant filed two reports on Form 8-K during the three months ended August 31, 2002.

Form 8-K dated July 10, 2002, was filed to report a change in the registrant's independent auditor. Based on the recommendation of the Audit Committee, the Board of Directors of the Partnership approved the dismissal of its independent auditors Arthur Andersen LLP and engaged the firm of Grant Thornton LLP as its new independent auditors for the fiscal year ended August 31, 2002, on July 8, 2002.

Form 8-K dated July 12, 2002, filed as exhibits the financial statements of U.S. Propane, L.P. and subsidiaries, as the General Partner of the Partnership

49

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on November 26, 2003.

HERITAGE PROPANE PARTNERS, L.P.

By U.S. Propane L.P, its General Partner.
By U.S. Propane, L.L.C., its General Partner

By: /s/ H. Michael Krimbill

H. Michael Krimbill
President and Chief Executive Officer and officer
duly authorized to sign on behalf of the registrant

50

INDEX TO FINANCIAL STATEMENTS

HERITAGE PROPANE PARTNERS, L.P. AND SUBSIDIARIES
(FORMERLY PEOPLES GAS COMPANY AND SURVIVING LEGAL ENTITY
IN THE SERIES OF TRANSACTIONS WITH U.S. PROPANE, L.P.)

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Report of Independent Certified Public Accountants (Fiscal Years 2002 and 2001).....

Report of Independent Public Accountants (Period Ended August 31, 2000 and Fiscal Year 1999).....

Consolidated Balance Sheets -
August 31, 2002 and 2001.....

Consolidated Statements of Operations -
Years Ended August 31, 2002 and 2001,
Eight Months Ended August 31, 2000 and 1999 (unaudited) and
Year Ended December 31, 1999

Consolidated Statements of Comprehensive Income (Loss) -
Years Ended August 31, 2002 and 2001,
Eight Months Ended August 31, 2000 and 1999 (unaudited) and
Year Ended December 31, 1999.....

Consolidated Statements of Partners' Capital -
Years Ended August 31, 2002 and 2001,
Eight Months Ended August 31, 2000 and
Year Ended December 31, 1999

Consolidated Statements of Cash Flows -
Years Ended August 31, 2002 and 2001
Eight Months Ended August 31, 2000
Year Ended December 31, 1999.....

Notes to Consolidated Financial Statements.....

HERITAGE PROPANE PARTNERS, L.P. AND SUBSIDIARIES (PREDECESSOR HERITAGE)
(THE PROPANE OPERATIONS OF HERITAGE PROPANE PARTNERS, L.P.,
PRIOR TO THE SERIES OF TRANSACTIONS WITH U.S. PROPANE, L.P.)

Report of Independent Public Accountants.....

Consolidated Statement of Operations -
Period Ended August 9, 2000

Consolidated Statement of Partners' Capital -
Period Ended August 9, 2000

Consolidated Statement of Cash Flows -
Period Ended August 9, 2000

Notes to Consolidated Financial Statements.....

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To the Partners of
Heritage Propane Partners, L.P.

We have audited the accompanying consolidated balance sheets of Heritage Propane Partners, L.P. (a Delaware limited partnership) and subsidiaries, formerly Peoples Gas Company, as of August 31, 2002 and 2001 and the related consolidated statements of operations, comprehensive income (loss), partners' capital, and cash flows for the years then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audits. The financial statements of Heritage Propane Partners, L.P. for the eight months ended August 31, 2000, and the year ended December 31, 1999, were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated October 26, 2000.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the 2002 and 2001 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Heritage Propane Partners, L.P. and subsidiaries as of August 31, 2002 and 2001, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed above, the financial statements of Heritage Propane Partners, L.P. for the eight months ended August 31, 2000, and for the year ended December 31, 1999, were audited by other auditors who have ceased operations. As described in Note 2, these financial statements have been revised to include the transitional disclosures required by Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, which was adopted by the Partnership as of September 1, 2001. Our audit procedures with respect to the disclosures in Note 2 for 2000 and 1999 included (i) agreeing the previously reported net income (loss) to the previously issued financial statements and the adjustments to reported net income (loss) representing amortization expense (including any related tax effects) recognized in those periods related to goodwill, to the Partnership's underlying records obtained from management, and (ii) testing the mathematical accuracy of the reconciliation of adjusted net income (loss) to reported net income (loss) and the related earnings-per-unit amounts. In our opinion, the disclosures for 2000 and 1999 in Note 2 are appropriate. However, we were not engaged to audit, review, or apply any procedures to the 2000 and 1999 financial statements of the Partnership other than with respect to such disclosures and the matter discussed in the following paragraphs and, accordingly, we do not express an opinion or any other form of assurance on the 2000 or 1999 financial statements taken as a whole.

As discussed above, the financial statements of Heritage Propane Partners, L.P. for the eight months ended August 31, 2000, were audited by other auditors who have ceased operations. As described in Note 2, these financial statements have been revised to include the disclosures required by Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation - Transition and Disclosures, which was adopted by the Partnership as of August 31, 2002. Our audit procedures with respect to the disclosures in Note 2 for 2000 included (i) agreeing the previously reported net loss to the previously issued financial statements and the adjustments to reported net loss

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representing compensation expense recognized in those periods under APB No. 25, Accounting for Stock Issued to Employees and the pro forma compensation expense under Statement of Financial Accounting Standards No. 123, Accounting for Stock Based Compensation, to the Partnership's underlying records obtained from management, and (ii) testing the mathematical accuracy of the reconciliation of pro forma net loss to reported net loss and the related earnings-per-unit amounts. In our opinion, the disclosures for 2000 in Note 2 are appropriate. However, we were not engaged to audit, review, or apply any procedures to the 2000 financial statements of the Partnership other than with respect to such disclosures and the matters discussed in the previous and following paragraphs and, accordingly, we do not express an opinion or any other form of assurance on the 2000 financial statements taken as a whole

F-2

As described in Note 2, amounts have been reclassified in the 2002, 2001 and 2000 consolidated statements of operations to reflect the adoption of Emerging Issues Task Force Issue No. 02-3, Issues Related to Accounting for Contracts Involved in Energy Trading and Risk Management Activities, by the Partnership as of August 31, 2002. As discussed above, the financial statements of Heritage Propane Partners, L.P. for the eight months ended August 31, 2000, were audited by other auditors who have ceased operations. We audited the reclassification adjustment described in Note 2 that was applied to the 2000 consolidated statement of operations. In our opinion, such reclassification adjustment is appropriate and has been properly applied. However, we were not engaged to audit, review, or apply any procedures to the 2000 financial statements of the Partnership other than with respect to such adjustment and the matters discussed in the preceding two paragraphs and, accordingly, we do not express an opinion or any other form of assurance on the 2000 financial statements taken as a whole.

Tulsa, Oklahoma

October 16, 2003 (except for Note 12, as to which the date is November 6, 2003)

F-3

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Partners of
Heritage Propane Partners, L.P.:

We have audited the accompanying consolidated balance sheets of Heritage Propane Partners, L.P. (a Delaware limited partnership) and subsidiaries, formerly Peoples Gas Company, as of August 31, 2001 and 2000 and the related consolidated statements of operations, comprehensive income (loss), partners' capital and cash flows for the year ended August 31, 2001, the eight month period ended August 31, 2000, and for each of the two years in the period ended December 31, 1999. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the

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financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Heritage Propane Partners, L.P. and subsidiaries, formerly Peoples Gas Company, as of August 31, 2001 and 2000, and the results of their operations and their cash flows for the year ended August 31, 2001, the eight month period ended August 31, 2000, and for each of the two years in the period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States.

/s/ Arthur Andersen LLP

Tulsa, Oklahoma
October 19, 2001

The report of Arthur Andersen LLP shown above is a copy of a previously issued report; Arthur Andersen LLP has not reissued this report.

F-4

HERITAGE PROPANE PARTNERS, L.P. AND SUBSIDIARIES (FORMERLY PEOPLES GAS COMPANY)

CONSOLIDATED BALANCE SHEETS (in thousands, except unit data)

| | August 31, 2002 ----- | August 31, 2001 ----- |
|---|-----------------------------|-----------------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 4,591 | \$ 5,626 |
| Marketable securities | 2,564 | 4,239 |
| Accounts receivable, net of allowance for doubtful accounts | 30,898 | 40,221 |
| Inventories | 48,187 | 66,814 |
| Assets from liquids marketing | 2,301 | 6,465 |
| Prepaid expenses and other | 6,846 | 14,898 |
| | ----- | ----- |
| Total current assets | 95,387 | 138,263 |
| PROPERTY, PLANT AND EQUIPMENT, net | 400,044 | 394,742 |

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| | | |
|---|------------|------------|
| INVESTMENT IN AFFILIATES | 7,858 | 6,920 |
| GOODWILL, net of amortization prior to adoption of SFAS No. 142 | 155,735 | 153,404 |
| INTANGIBLES AND OTHER ASSETS, net | 58,240 | 64,838 |
| | ----- | ----- |
| Total assets | \$ 717,264 | \$ 758,167 |
| | ===== | ===== |
| LIABILITIES AND PARTNERS' CAPITAL | | |
| CURRENT LIABILITIES: | | |
| Working capital facility | \$ 30,200 | \$ 19,900 |
| Accounts payable | 40,929 | 43,164 |
| Accounts payable to related companies | 5,002 | 7,937 |
| Accrued and other current liabilities | 23,962 | 33,404 |
| Liabilities from liquids marketing | 1,818 | 7,130 |
| Current maturities of long-term debt | 20,158 | 16,120 |
| | ----- | ----- |
| Total current liabilities | 122,069 | 127,655 |
| LONG-TERM DEBT, less current maturities | 420,021 | 423,748 |
| MINORITY INTERESTS | 3,564 | 5,350 |
| | ----- | ----- |
| Total liabilities | 545,654 | 556,753 |
| | ----- | ----- |
| COMMITMENTS AND CONTINGENCIES | | |
| PARTNERS' CAPITAL: | | |
| Common Unitholders (15,815,847 and 14,260,316 units issued and outstanding at August 31, 2002 and 2001, respectively) | 173,677 | 190,548 |
| Class B Subordinated Unitholders (1,382,514 units issued and outstanding at August 31, 2001) | -- | 15,532 |
| Class C Unitholders (1,000,000 units issued and outstanding at August 31, 2002 and 2001) | -- | -- |
| General Partner | 1,585 | 1,875 |
| Accumulated other comprehensive loss | (3,652) | (6,541) |
| | ----- | ----- |
| Total partners' capital | 171,610 | 201,414 |
| | ----- | ----- |
| Total liabilities and partners' capital | \$ 717,264 | \$ 758,167 |
| | ===== | ===== |

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

F-5

HERITAGE PROPANE PARTNERS, L.P. AND SUBSIDIARIES
(FORMERLY PEOPLES GAS COMPANY)

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

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| | For the Years Ended August 31, | | For the Ende |
|--|-----------------------------------|------------|-----------------|
| | 2002 | 2001 | 2000 |
| REVENUES: | | | |
| Retail fuel | \$ 365,334 | \$ 440,527 | \$ 43,815 |
| Wholesale fuel | 41,204 | 59,879 | 3,807 |
| Liquids marketing, net | 542 | 841 | 724 |
| Other | 55,245 | 42,728 | 3,188 |
| Total revenues | 462,325 | 543,975 | 51,534 |
| COSTS AND EXPENSES: | | | |
| Cost of products sold | 238,185 | 306,556 | 29,962 |
| Operating expenses | 133,203 | 126,849 | 16,581 |
| Depreciation and amortization | 36,998 | 40,431 | 4,686 |
| Selling, general and administrative | 12,978 | 15,716 | 1,019 |
| Total costs and expenses | 421,364 | 489,552 | 52,248 |
| OPERATING INCOME (LOSS) | 40,961 | 54,423 | (714) |
| OTHER INCOME (EXPENSE): | | | |
| Interest expense | (37,341) | (35,567) | (2,409) |
| Equity in earnings (losses) of affiliates | 1,338 | 1,250 | (67) |
| Gain on disposal of assets | 812 | 812 | 121 |
| Other | (294) | (394) | (478) |
| INCOME (LOSS) BEFORE MINORITY INTERESTS AND INCOME TAXES | 5,476 | 20,524 | (3,547) |
| Minority interests | (574) | (814) | 80 |
| INCOME (LOSS) BEFORE INCOME TAXES | 4,902 | 19,710 | (3,467) |
| Income taxes | -- | -- | 379 |
| NET INCOME (LOSS) | 4,902 | 19,710 | (3,846) |
| GENERAL PARTNER'S INTEREST IN NET INCOME (LOSS) | 918 | 831 | (46) |
| LIMITED PARTNERS' INTEREST IN NET INCOME (LOSS) | \$ 3,984 | \$ 18,879 | \$ (3,800) |
| BASIC NET INCOME (LOSS) PER LIMITED PARTNER UNIT | \$ 0.25 | \$ 1.43 | \$ (0.37) |

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| | | | |
|---|---------------------|---------------------|---------------------|
| BASIC AVERAGE NUMBER OF UNITS OUTSTANDING | 15,738,621 ===== | 13,223,184 ===== | 10,225,387 ===== |
| DILUTED NET INCOME (LOSS) PER LIMITED PARTNER UNIT | \$ 0.25 ===== | \$ 1.42 ===== | \$ (0.37) ===== |
| DILUTED AVERAGE NUMBER OF UNITS OUTSTANDING | 15,777,307 ===== | 13,254,908 ===== | 10,225,387 ===== |

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

F-6

HERITAGE PROPANE PARTNERS, L.P. AND SUBSIDIARIES
(FORMERLY PEOPLES GAS COMPANY)

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(in thousands)

| | For the Years Ended August 31, | | For the Ended |
|--|-----------------------------------|--------------------|---------------------|
| | 2002 | 2001 | 2000 |
| | ----- | ----- | ----- |
| Net income (loss) | \$ 4,902 | \$ 19,710 | \$ (3,846) |
| Other comprehensive income: | | | |
| Transition adjustment for adoption of SFAS No. 133 | -- | 5,429 | -- |
| Change in value of derivative instruments | 4,464 | (9,893) | -- |
| Change in value of available-for-sale securities | (1,575) | (2,077) | -- |
| | ----- | ----- | ----- |
| Comprehensive income (loss) | \$ 7,791 ===== | \$ 13,169 ===== | \$ (3,846) ===== |
| RECONCILIATION OF ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) | | | |
| Balance, beginning of period | \$ (6,541) | \$ -- | \$ -- |
| Transition adjustment for adoption of | | | |

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| | | | |
|---|------------|------------|-------|
| SFAS No. 133 | -- | 5,429 | -- |
| Current period reclassification to earnings | 7,016 | (3,844) | -- |
| Current period change | (4,127) | (8,126) | -- |
| | ----- | ----- | ----- |
| Balance, end of period | \$ (3,652) | \$ (6,541) | \$ -- |
| | ===== | ===== | ===== |

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

F-7

HERITAGE PROPANE PARTNERS, L.P. AND SUBSIDIARIES
(FORMERLY PEOPLES GAS COMPANY)

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

| | Number of Units | | |
|--|-----------------|-------------------------|---------|
| | Common | Class B Subordinated | Subordi |
| | ----- | ----- | ----- |
| BALANCE, DECEMBER 31, 1998 | 1,294,873 | 437,398 | |
| Net income | -- | -- | |
| Dividends paid to parent | -- | -- | |
| | ----- | ----- | ----- |
| BALANCE, DECEMBER 31, 1999 | 1,294,873 | 437,398 | |
| Dividends paid to parent | -- | -- | |
| Liabilities retained by parent | -- | -- | |
| Merger with AGL, Atmos, and Piedmont | -- | -- | |
| Merger with Predecessor Heritage | 8,379,273 | 1,414,073 | 1,382 |
| General Partner capital contribution | -- | -- | |
| Other | -- | -- | |
| Net loss | -- | -- | |
| | ----- | ----- | ----- |
| BALANCE, AUGUST 31, 2000 | 9,674,146 | 1,851,471 | 1,382 |
| Unit distribution | -- | -- | |
| Issuance of Common Units | 2,500,000 | -- | |
| Conversion of Phantom Units | 72,050 | -- | |
| Issuance of Restricted Common Units | 216,917 | -- | |
| General Partner capital contribution | (54,268) | -- | |
| Conversion of Subordinated Units | 1,851,471 | (1,851,471) | |
| Cumulative effect of the adoption of SFAS 133 | -- | -- | |
| Net change in accumulated other comprehensive loss per accompanying statements | -- | -- | |
| Other | -- | -- | |
| Net income | -- | -- | |
| | ----- | ----- | ----- |

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| | | | |
|--|------------|-------|---------|
| BALANCE, AUGUST 31, 2001 | 14,260,316 | -- | 1,382 |
| Unit distribution | -- | -- | |
| Conversion of Phantom Units | 11,750 | -- | |
| Conversion of Subordinated Units | 1,382,514 | -- | (1,382) |
| Issuance of units upon conversion of minority interest | 162,913 | -- | |
| General Partner capital contribution | (1,646) | -- | |
| Net change in accumulated other comprehensive loss per accompanying statements | -- | -- | |
| Other | -- | -- | |
| Net income | -- | -- | |
| | ----- | ----- | ----- |
| BALANCE, AUGUST 31, 2002 | 15,815,847 | -- | |
| | ===== | ===== | ===== |

| | Common | Class B Subordinated | Subordi |
|--|-----------|----------------------|---------|
| | ----- | ----- | ----- |
| BALANCE, DECEMBER 31, 1998 | \$ 11,659 | \$ 3,898 | \$ |
| Net income | 1,323 | 441 | |
| Dividends paid to parent | (1,688) | (563) | |
| | ----- | ----- | ----- |
| BALANCE, DECEMBER 31, 1999 | 11,294 | 3,776 | |
| Dividends paid to parent | (1,132) | (377) | |
| Liabilities retained by parent | 21,080 | 7,051 | |
| Merger with AGL, Atmos, and Piedmont | 83,410 | 28,085 | |
| Merger with Predecessor Heritage | (4,080) | (14,657) | 17 |
| General Partner capital contribution | -- | -- | |
| Other | (1,502) | (285) | |
| Net loss | (2,849) | (463) | |
| | ----- | ----- | ----- |
| BALANCE, AUGUST 31, 2000 | 106,221 | 23,130 | 16 |
| Unit distribution | (23,183) | (4,397) | (3) |
| Issuance of Common Units | 66,046 | -- | |
| Conversion of Phantom Units | 323 | -- | |
| Issuance of Restricted Common Units | 6,050 | -- | |
| General Partner capital contribution | (1,520) | -- | |
| Conversion of Subordinated Units | 24,214 | (24,214) | |
| Cumulative effect of the adoption of SFAS 133 | -- | -- | |
| Net change in accumulated other comprehensive loss per accompanying statements | -- | -- | |
| Other | 1,349 | -- | |
| Net income | 11,048 | 5,481 | 2 |
| | ----- | ----- | ----- |
| BALANCE, AUGUST 31, 2001 | 190,548 | -- | 15 |
| Unit distribution | (38,159) | -- | (1) |
| Conversion of Phantom Units | -- | -- | |
| Conversion of Subordinated Units | 15,137 | -- | (15) |
| Issuance of units upon conversion of | | | |

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| | | | |
|--|------------|-------|-------|
| minority interest | 1,729 | -- | |
| General Partner capital contribution | (32) | -- | |
| Net change in accumulated other comprehensive loss per accompanying statements | -- | -- | |
| Other | 1,821 | -- | |
| Net income | 2,633 | -- | 1 |
| | ----- | ----- | ----- |
| BALANCE, AUGUST 31, 2002 | \$ 173,677 | \$ -- | \$ -- |
| | ===== | ===== | ===== |

| | General Partner | Accumulated Other Comprehensive Income (Loss) | Total |
|--|-----------------|---|-------|
| | ----- | ----- | ----- |
| BALANCE, DECEMBER 31, 1998 | \$ 39 | \$ -- | \$ 15 |
| Net income | 4 | -- | 1 |
| Dividends paid to parent | (6) | -- | (2) |
| | ----- | ----- | ----- |
| BALANCE, DECEMBER 31, 1999 | 37 | -- | 15 |
| Dividends paid to parent | (4) | -- | (1) |
| Liabilities retained by parent | 71 | -- | 28 |
| Merger with AGL, Atmos, and Piedmont | 843 | -- | 112 |
| Merger with Predecessor Heritage | (523) | -- | (2) |
| General Partner capital contribution | 581 | -- | |
| Other | (20) | -- | (2) |
| Net loss | (46) | -- | (3) |
| | ----- | ----- | ----- |
| BALANCE, AUGUST 31, 2000 | 939 | -- | 146 |
| Unit distribution | (663) | -- | (31) |
| Issuance of Common Units | -- | -- | 66 |
| Conversion of Phantom Units | -- | -- | |
| Issuance of Restricted Common Units | -- | -- | 6 |
| General Partner capital contribution | 768 | -- | |
| Conversion of Subordinated Units | -- | -- | |
| Cumulative effect of the adoption of SFAS 133 | -- | 5,429 | 5 |
| Net change in accumulated other comprehensive loss per accompanying statements | -- | (11,970) | (11) |
| Other | -- | -- | 1 |
| Net income | 831 | -- | 19 |
| | ----- | ----- | ----- |
| BALANCE, AUGUST 31, 2001 | 1,875 | (6,541) | 201 |
| Unit distribution | (1,240) | -- | (41) |
| Conversion of Phantom Units | -- | -- | |
| Conversion of Subordinated Units | -- | -- | |
| Issuance of units upon conversion of minority interest | -- | -- | 1 |
| General Partner capital contribution | 32 | -- | |
| Net change in accumulated other comprehensive loss per accompanying statements | -- | 2,889 | 2 |
| Other | -- | -- | 1 |

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| | | | |
|--------------------------|----------|------------|--------|
| Net income | 918 | -- | 4 |
| | ----- | ----- | ----- |
| BALANCE, AUGUST 31, 2002 | \$ 1,585 | \$ (3,652) | \$ 171 |
| | ===== | ===== | ===== |

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

F-8

HERITAGE PROPANE PARTNERS, L.P. AND SUBSIDIARIES
(FORMERLY PEOPLES GAS COMPANY)

CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

| | For the Years Ended August 31, | | For Mon Au |
|---|-----------------------------------|-----------|------------------|
| | 2002 | 2001 | |
| | ----- | ----- | ----- |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income (loss) | \$ 4,902 | \$ 19,710 | \$ |
| Reconciliation of net income (loss) to net cash provided by operating activities- | | | |
| Depreciation and amortization | 36,998 | 40,431 | |
| Provision for loss on accounts receivable | 887 | 4,055 | |
| Gain on disposal of assets | (812) | (812) | |
| Deferred compensation on restricted units and long-term incentive plan | 1,878 | 1,079 | |
| Undistributed earnings (losses) of affiliates | (938) | (1,125) | |
| Minority interests | (111) | 463 | |
| Deferred income taxes | -- | -- | |
| Changes in assets and liabilities, net of effect of acquisitions: | | | |
| Accounts receivable | 9,180 | (4,533) | |
| Inventories | 17,827 | (24,158) | |
| Assets from liquids marketing | 4,164 | (2,332) | |
| Prepaid and other expenses | 8,086 | (12,331) | |
| Intangibles and other assets | 1,197 | 1,730 | |
| Accounts payable | (4,094) | (3,166) | |
| Accounts payable to related companies | (2,935) | 4,123 | |
| Accrued and other current liabilities | (5,464) | 1,476 | |
| Liabilities from liquids marketing | (5,312) | 3,446 | |
| | ----- | ----- | |
| Net cash provided by operating activities | 65,453 | 28,056 | |
| | ----- | ----- | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Cash paid for acquisitions, net of cash acquired | (19,742) | (94,860) | (|
| Capital expenditures | (27,072) | (23,854) | |
| Proceeds from the sale of assets | 13,336 | 2,620 | |
| Investment in marketable securities | (34) | (6,219) | |

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| | | | |
|---|-----------|-----------|-------|
| Other | 95 | -- | |
| | ----- | ----- | ----- |
| Net cash used in investing activities | (33,417) | (122,313) | (|
| | ----- | ----- | ----- |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Proceeds from borrowings | 164,715 | 356,748 | |
| Principal payments on debt | (156,584) | (295,788) | |
| Net proceeds from issuance of Common Units | -- | 66,046 | |
| Net proceeds from issuance of Subordinated Units | -- | -- | |
| Debt issuance costs | -- | (441) | |
| Capital contributions | -- | -- | |
| Unit distributions | (41,145) | (31,527) | |
| Dividends paid to parent | -- | -- | |
| Other | (57) | -- | |
| | ----- | ----- | ----- |
| Net cash provided by (used in) financing activities | (33,071) | 95,038 | |
| | ----- | ----- | ----- |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | | | |
| | (1,035) | 781 | |
| CASH AND CASH EQUIVALENTS, beginning of period | | | |
| | 5,626 | 4,845 | |
| | ----- | ----- | ----- |
| CASH AND CASH EQUIVALENTS, end of period | | | |
| | \$ 4,591 | \$ 5,626 | \$ |
| | ===== | ===== | ===== |

F-9

HERITAGE PROPANE PARTNERS, L.P. AND SUBSIDIARIES
(FORMERLY PEOPLES GAS COMPANY)

CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

| | For the Years Ended August 31, | |
|---|-----------------------------------|-----------|
| | 2002 | 2001 |
| | ----- | ----- |
| NONCASH FINANCING ACTIVITIES: | | |
| Notes payable incurred on noncompete agreements | \$ 2,737 | \$ 10,030 |
| | ===== | ===== |
| Issuance of Common Units upon conversion of minority interest | \$ 1,729 | \$ -- |
| | ===== | ===== |
| General Partner capital contribution | \$ -- | \$ (752) |
| | ===== | ===== |
| Issuance of Restricted Common Units | \$ -- | \$ 6,050 |
| | ===== | ===== |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Cash paid during the period for interest | \$ 37,610 | \$ 35,541 |
| | ===== | ===== |
| Cash paid to parent for income taxes under tax sharing agreement, net | \$ -- | \$ -- |

=====

=====

The accompanying notes are an integral part of these financial statements

F-10

HERITAGE PROPANE PARTNERS, L.P. AND SUBSIDIARIES
(FORMERLY PEOPLES GAS COMPANY)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollar amounts in thousands, except unit and per unit data)

1. OPERATIONS AND ORGANIZATION:

In August 2000, TECO Energy, Inc. ("TECO"), Atmos Energy Corporation ("Atmos Energy"), Piedmont Natural Gas Co., Inc. ("Piedmont Natural Gas"), and AGL Resources, Inc. ("AGL Resources") contributed each company's propane operations, Peoples Gas Company ("Peoples Gas"), United Cities Propane Gas, Inc. ("United Cities"), Piedmont Propane Company ("Piedmont") and AGL Propane, Inc., ("AGL") respectively, to U.S. Propane L.P., ("U.S. Propane") in exchange for equity interests in U.S. Propane. The merger was accounted for as an acquisition using the purchase method of accounting with Peoples Gas being the acquirer. Accordingly, Peoples Gas' assets and liabilities were recorded at historical cost and the assets and liabilities of United Cities, Piedmont and AGL were recorded at fair market value, as determined based on a valuation and appraisal. The purchase allocations were as follows:

| | |
|--|-----------|
| Purchase price of Piedmont, AGL and United Cities | \$112,338 |
| Net book value of Piedmont, AGL and United Cities | 82,765 |
| | ----- |
| Step-up of net book value, allocated to property, plant and equipment | \$ 29,573 |
| | ===== |

In August 2000, U.S. Propane acquired all of the outstanding common stock of Heritage Holdings, Inc., the former General Partner of Heritage Propane Partners, L.P. (the "former General Partner" or "Heritage Holdings") for \$120,000. By virtue of Heritage Holdings' former general partner and limited partner interests in Heritage Propane Partners, L.P., U.S. Propane gained control of Heritage Propane Partners, L.P. Simultaneously, U.S. Propane transferred its propane operations, consisting of its interest in four separate limited liability companies, AGL Propane, L.L.C., Peoples Gas Company, L.L.C., United Cities Propane Gas, L.L.C. and Retail Propane Company, L.L.C. (former Piedmont operations), (collectively, the "Propane LLCs"), to Heritage Propane Partners, L.P. for \$181,395 plus working capital. The \$181,395 was payable \$139,552 in cash, \$31,843 of assumed debt, and the issuance of 372,392 Common Units of Heritage Propane Partners, L.P. valued at \$7,348 and a 1.0101% limited partner interest in Heritage Propane Partners, L.P.'s operating partnership, Heritage Operating, L.P., valued at \$2,652. The purchase price and the exchange price for the Common Units were approved by an independent committee of the Board of Directors of Heritage Holdings. The exchange price for the Common Units was \$19.73125 per unit under a formula based on the average closing price of

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Heritage Propane Partners, L.P.'s Common Units on the New York Stock Exchange for the twenty (20) day period beginning ten (10) days prior to the public announcement of the transaction on June 15, 2000 (the "Formula Price"). Subsequent to August 31, 2000, payments totaling approximately \$12,900 were made for the working capital adjustment, of which \$5,000 was accrued at August 31, 2000.

Concurrent with the acquisition, Heritage Operating, L.P. borrowed \$180,000 from several institutional investors and Heritage Propane Partners, L.P. sold 1,161,814 Common Units and 1,382,514 Class B Subordinated Units in a private placement to the former shareholders of Heritage Holdings based on the Formula Price resulting in net proceeds of \$50,203. The total of these proceeds were utilized to finance the transaction and retire a portion of existing debt.

The merger was accounted for as a reverse acquisition in accordance with Accounting Principles Board (APB) Opinion No. 16. The propane operations of Heritage Propane Partners, L.P. prior to the series of transactions with U.S. Propane are referred to as Predecessor Heritage. Although Predecessor Heritage is the surviving entity for legal purposes, U.S. Propane's propane operations is the acquirer for accounting purposes. The assets and liabilities of Predecessor Heritage have been recorded at fair value to the extent acquired by U.S. Propane's propane operations, approximately 36%, in accordance with Emerging Issues Task Force (EITF) Issue No. 90-13, Accounting for Simultaneous Common Control Mergers. The assets and liabilities of U.S. Propane have been recorded at historical cost, as recorded in the U.S. Propane transaction described above. The combined operations of Predecessor Heritage and U.S. Propane are referred to herein as "Heritage" or the "Partnership". Although the equity accounts of Peoples Gas survive the merger, Predecessor Heritage's partnership structure and partnership

F-11

units survive. Accordingly, the equity accounts of Peoples Gas have been restated based on the general partner interest and Common Units received by Peoples Gas in the merger.

The excess purchase price over Predecessor Heritage's cost was determined as follows:

| | |
|--|-----------|
| Net book value of Predecessor Heritage at August 9, 2000 | \$ 35,716 |
| Equity investment | 50,203 |
| | ----- |
| | 85,919 |
| Percent of Predecessor Heritage acquired by U.S. Propane | 36% |
| | ----- |
| Equity interest acquired | \$ 30,931 |
| | ===== |
| | |
| Purchase price | \$120,000 |
| Equity interest acquired | 30,931 |
| | ----- |
| Excess purchase price over Predecessor Heritage cost | \$ 89,069 |
| | ===== |

The excess purchase price over Predecessor Heritage cost was allocated as follows:

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| | |
|--|-----------|
| Property, plant and equipment (25 year life) | \$ 11,180 |
| Customer lists (15 year life) | 5,935 |
| Goodwill (30 year life) | 71,954 |
| | ----- |
| | \$ 89,069 |
| | ===== |

The accompanying financial statements for the period ended December 31, 1999 have been presented on a carve-out basis and reflect the historical results of operations and cash flows of Peoples Gas. As discussed further in Note 8, certain expenses in the financial statements include allocations from TECO and other wholly-owned subsidiaries of TECO. Management believes that the allocations were made on a reasonable basis; however, the allocations of costs and expenses do not necessarily indicate the costs that would have been incurred by Peoples Gas on a stand-alone basis. Also, the financial statements may not necessarily reflect what the results of operations and cash flows of Peoples Gas would have been if Peoples Gas had been a separate, stand-alone company during the periods presented.

The following unaudited pro forma consolidated results of operations are presented as if the series of transactions with U.S. Propane and Predecessor Heritage had been made at the beginning of the periods presented.

| | 8-months Ended August 31, 2000 | 12-months Ended December 31, 1999 |
|---|--------------------------------------|---|
| | ----- | ----- |
| Net revenues | \$ 305,017 | \$ 299,600 |
| Net income (loss) | \$ 4,712 | \$ (1,662) |
| Basic and diluted earnings (loss) per Common Unit | \$ 0.36 | \$ (0.14) |

The pro forma consolidated results of operations include adjustments to give effect to amortization of goodwill, interest expense on acquisition and assumed debt, and certain other adjustments, including the elimination of income taxes. The unaudited pro forma information is not necessarily indicative of the results of operations that would have occurred had the transactions been made at the beginning of the periods presented or the future results of the combined operations.

Peoples Gas had a fiscal year-end of December 31, however, Heritage continues to have Predecessor Heritage's August 31 year-end. Accordingly, the eight-month period ended August 31, 2000 is a transition period under the rules of the Securities and Exchange Commission.

In order to simplify Heritage's obligation under the laws of several jurisdictions in which Heritage conducts business, Heritage's activities are conducted through a subsidiary operating partnership Heritage Operating, L.P. (the "Operating Partnership"). The Operating Partnership sells propane and propane-related products to more than 600,000 active residential, commercial, industrial and agricultural customers in 28 states. Heritage is also a wholesale propane supplier in the southwestern and southeastern United States and in Canada, the latter through participation in MP Energy Partnership. MP Energy Partnership is a Canadian partnership, engaged in supplying the Partnership's northern U.S. locations and lower-margin wholesale distribution, in which Heritage owns a 60%

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F-12

interest. Heritage buys and sells financial instruments for its own account through its wholly owned subsidiary, Heritage Energy Resources L.L.C. ("Resources").

On February 4, 2002, the Partnership's Common Unitholders, at a special meeting, approved the substitution of U.S. Propane as the successor General Partner of the Partnership replacing Heritage Holdings. Heritage Holdings exchanged its general partner interest in Heritage and the Incentive Distribution Rights (which are described in Note 6), for 158,026 Common Units, and its 1.0101% general partner interest in the Operating Partnership for 162,913 Common Units. The 1.0101% limited partner interest in the Operating Partnership owned by U.S. Propane converted to a 1.0101% general partner interest in the Operating Partnership and 158,026 of the Common Units owned by U.S. Propane converted into a 1% general partner interest in the Partnership plus the Incentive Distribution Rights.

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

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements of the Partnership include the accounts of its subsidiaries, including the Operating Partnership, MP Energy Partnership, Heritage Service Corp., Guilford Gas Service, Inc., Resources, and the Propane LLCs. A minority interest liability and minority interest expense is recorded for all partially owned subsidiaries. Heritage accounts for its 50% partnership interest in Bi-State Propane, another propane retailer, under the equity method. All significant intercompany transactions and accounts have been eliminated in consolidation. The accounts of the Operating Partnership are included based on the determination that Heritage possesses a controlling financial interest through a direct ownership of a 98.9899% voting interest and its ability to exert control over the Operating Partnership. For purposes of maintaining partner capital accounts, Heritage's Partnership Agreement specifies that items of income and loss shall be allocated among the partners in accordance with their percentage interests. Normal allocations according to percentage interests are made, however, only after giving effect to any priority income allocations in an amount equal to the incentive distributions that are allocated 100% to the General Partner. At August 31, 2002, as successor General Partner, U.S. Propane's 1.0101% general partner interest in the Operating Partnership was accounted for in the consolidated financial statements as a minority interest. For the year ended August 31, 2001, Heritage Holdings' 1.0101% general partner interest and U.S. Propane's 1.0101% limited partner interest in the Operating Partnership were accounted for in the consolidated financial statements as minority interests.

REVENUE RECOGNITION

Sales of propane, propane appliances, parts, and fittings are recognized at the later of the time of delivery of the product to the customer or the time of sale or installation. Revenue from service labor is recognized upon completion of the service and tank rent is recognized ratably over the period it is earned. Shipping and handling revenues are included in the price of propane charged to customers, and thus are classified as revenues.

COSTS AND EXPENSES

Costs of products sold include actual cost of fuel sold adjusted for the effects of qualifying cash flow hedges, storage fees and inbound freight, and the cost of appliances, parts, and fittings. Operating expenses include all costs incurred to provide products to customers, including compensation for operations

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personnel, insurance costs, vehicle maintenance, advertising costs, shipping and handling costs, purchasing costs, and plant operations. Selling, general and administrative expenses include all corporate expenses and compensation for corporate personnel.

CASH AND CASH EQUIVALENTS

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

F-13

ACCOUNTS RECEIVABLE

Heritage grants credit to its customers for the purchase of propane and propane-related products. Accounts receivable consisted of the following:

| | August 31, 2002 | August 31, 2001 |
|--|--------------------|--------------------|
| | ----- | ----- |
| Accounts receivable | \$33,402 | \$43,797 |
| Less - allowance for doubtful accounts | 2,504 | 3,576 |
| | ----- | ----- |
| Total, net | \$30,898 | \$40,221 |
| | ===== | ===== |

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

| | August 31, 2002 | August 31, 2001 |
|--|--------------------|--------------------|
| | ----- | ----- |
| Balance, beginning of the year | \$ 3,576 | \$ -- |
| Provision for loss on accounts receivable | 887 | 4,055 |
| Accounts receivable written off, net of recoveries | (1,959) | (479) |
| | ----- | ----- |
| Balance, end of year | \$ 2,504 | \$ 3,576 |
| | ===== | ===== |

INVENTORIES

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

August 31, August 31,

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| | 2002 ----- | 2001 ----- |
|--------------------------------|---------------|---------------|
| Fuel | \$38,523 | \$56,975 |
| Appliances, parts and fittings | 9,664 | 9,839 |
| | ----- | ----- |
| Total inventories | \$48,187 | \$66,814 |
| | ===== | ===== |

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Expenditures for maintenance and repairs are expensed as incurred. Expenditures to refurbish tanks that either extend the useful lives of the tanks or prevent environmental contamination are capitalized and depreciated over the remaining useful life of the tanks. Additionally, Heritage capitalizes certain costs directly related to the installation of company-owned tanks, including internal labor costs. Components and useful lives of property, plant and equipment were as follows:

| | August 31, 2002 ----- | August 31, 2001 ----- |
|--|-----------------------------|-----------------------------|
| Land and improvements | \$ 20,981 | \$ 21,244 |
| Buildings and improvements (10 to 30 years) | 29,145 | 27,871 |
| Bulk storage, equipment and facilities (3 to 30 years) | 39,908 | 34,431 |
| Tanks and other equipment (5 to 30 years) | 298,540 | 287,155 |
| Vehicles (5 to 10 years) | 63,755 | 52,177 |
| Furniture and fixtures (5 to 10 years) | 10,407 | 6,852 |
| Other (5 to 10 years) | 3,442 | 3,242 |
| | ----- | ----- |
| | 466,178 | 432,972 |
| Less - Accumulated depreciation | (72,822) | (47,036) |
| | ----- | ----- |
| | 393,356 | 385,936 |
| Plus - Construction work-in-process | 6,688 | 8,806 |
| | ----- | ----- |
| | 400,044 | 394,742 |
| Property, plant and equipment, net | \$ 400,044 | \$ 394,742 |
| | ===== | ===== |

F-14

INTANGIBLES AND OTHER ASSETS

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

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| | August 31, 2002 | | August 31, 2001 | |
|---------------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Amortized intangible assets | | | | |
| Noncompete agreements (5 to 15 years) | \$ 41,994 | \$ (10,924) | \$ 40,764 | \$ (10,924) |
| Customer lists (15 years) | 27,245 | (4,160) | 26,903 | (4,160) |
| Financing costs (3 to 15 years) | 4,225 | (1,291) | 4,225 | (1,291) |
| Consulting agreements (2 to 7 years) | 618 | (390) | 618 | (390) |
| Total | 74,082 | (16,765) | 72,510 | (16,765) |
| Unamortized intangible assets | | | | |
| Trademarks | 864 | -- | -- | -- |
| Other assets | 59 | -- | 1,212 | -- |
| Total intangibles and other assets | \$ 75,005 | \$ (16,765) | \$ 73,722 | \$ (16,765) |

Aggregate amortization expense of intangible assets was \$8,152 and \$6,879 for the years ended August 31, 2002 and 2001 respectively, and \$1,108 and \$199 for the eight months ended August 31, 2000 and 1999, respectively and \$200 for the year ended December 31, 1999. The estimated aggregate amortization expense for the next five fiscal years is \$7,701 for 2003; \$7,199 for 2004; \$6,841 for 2005; \$6,397 for 2006; and \$6,112 for 2007.

GOODWILL

Goodwill is associated with acquisitions made for Heritage's domestic retail segment; therefore, all goodwill is recorded in this segment. Of the \$155,735 balance in goodwill, \$24,579 is expected to be tax deductible. Goodwill is tested for impairment at the end of each fiscal year end in accordance with SFAS 142. The changes in the carrying amount of goodwill for the years ended August 31, 2001 and 2002 were as follows:

| | |
|---|------------|
| Balance as of August 31, 2000 | \$ 133,569 |
| Goodwill acquired during the year | 25,053 |
| Accumulated amortization prior to the adoption of SFAS No 142 | (5,218) |
| Impairment losses | -- |
| Goodwill written off to sale of business | -- |
| Balance as of August 31, 2001 | 153,404 |
| Goodwill acquired during the year | 6,464 |
| Impairment losses | -- |
| Goodwill written off to sale of business | (4,133) |
| Balance as of August 31, 2002 | \$ 155,735 |

LONG-LIVED ASSETS

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Heritage reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. If such a review should indicate that the carrying amount of long-lived assets is not recoverable, Heritage reduces the carrying amount of such assets to fair value. No impairment of long-lived assets was recorded during the years ended August 31, 2002 and 2001, and December 31, 1999 or the period ended August 31, 2000.

ACCRUED AND OTHER CURRENT LIABILITIES

Accrued and other current liabilities consisted of the following:

| | August 31, 2002 ----- | August 31, 2001 ----- |
|---|-----------------------------|-----------------------------|
| Interest payable | \$ 4,100 | \$ 4,542 |
| Wages and payroll taxes | 1,869 | 5,117 |
| Deferred tank rent | 3,585 | 3,019 |
| Advanced budget payments and unearned revenue | 8,116 | 5,883 |
| Customer deposits | 2,175 | 2,425 |
| Taxes other than income | 2,027 | 2,430 |
| Derivative instruments | -- | 4,556 |
| Other | 2,090 | 5,432 |
| | ----- | ----- |
| Accrued and other current liabilities | \$23,962 ===== | \$33,404 ===== |

INCOME TAXES

Prior to the series of transactions that formed U.S. Propane, Peoples Gas followed the liability method of accounting for income taxes in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (SFAS 109). Under SFAS 109, deferred income taxes are recorded based upon differences between the financial reporting and tax basis of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the underlying assets are received and liabilities are settled. TECO retained all tax liabilities related to Peoples Gas that may have existed as of August 9, 2000.

Heritage is a limited partnership. As a result, Heritage's earnings or losses for federal and state income tax purposes are included in the tax returns of the individual partners. Accordingly, because of the merger, no recognition has been given to income taxes in the accompanying financial statements of Heritage for the years ended August 31, 2002 and 2001 or the period ended August 31, 2000, except those incurred by Peoples Gas prior to the series of transactions with U.S. Propane and Predecessor Heritage. Net earnings for financial statement purposes may differ significantly from taxable income reportable to unit holders as a result of differences between the tax basis and financial reporting basis of assets and liabilities and the taxable income allocation requirements under the Partnership Agreement.

STOCK BASED COMPENSATION PLANS

The Partnership accounts for its Restricted Unit Plan and Long-Term Incentive Plan using APB Opinion No. 25 Accounting for Stock Issued to Employees (APB 25). These plans are classified as variable plans so that estimates of compensation are required based on a combination of the fair market value of the Common Units as of the end of the reporting period and the extent or degree of compliance

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with the performance criteria. Heritage follows the disclosure only provisions of Statement of Financial Accounting Standards No. 123 Accounting for Stock-based Compensation (SFAS 123), as amended by Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure (SFAS 148). Heritage adopted the fair value recognition provisions of SFAS 123 effective as of September 1, 2002. Heritage adopted the fair value recognition provisions following the modified prospective method of adoption described in SFAS 148. Following adoption, deferred compensation expense that is recognized will be the same as that which would have been recognized had the fair

F-16

value recognition provisions of SFAS 123 been applied to all awards under the Restricted Unit Plan and the Long Term Incentive Plan granted after its original effective date. Results from prior years have not been restated.

The fair value of each unit grant is estimated on the date of grant considering the market value of a Common Unit reduced by the discounted value of expected cash distributions to be made during the vesting period, as the units do not receive cash distributions until the vesting period is complete. The vesting period is assumed to be three years for all units granted and the weighted average risk free interest rate applied to grants during each of the years was: 5.6% for 2000, 5.96% for 2001 and 6.18% for 2002. Annual average cash distributions at the grant date were estimated to be \$2.10 for 2000, \$2.35 for 2001 and \$2.37 for 2002. There were no units outstanding at December 31, 1999. The following table illustrates the effect on limited partners' interest in net income (loss) and the basic and diluted net income (loss) per limited partner unit if Heritage had applied the fair value recognition provisions of SFAS 123 to the Restricted Unit Plan and the Long-Term Incentive Plan for all of the periods presented.

| | Year Ended August 31, 2002 ----- | Year Ended August 31, 2001 ----- | E ----- 2000 ----- |
|---|---|---|-----------------------------|
| NET INCOME (LOSS) PER LIMITED PARTNER UNIT: | | | |
| Limited partners' interest in net income (loss) | \$ 3,984 | \$ 18,879 | \$ (3, |
| Add: Deferred compensation expense net of General Partner's and minority interest included in limited partners' interest in net income (loss) | 1,841 | 1,057 | |
| Deduct: Deferred compensation expense net of General Partner's and minority interest determined under the fair value based method | (968) | (1,079) | (|
| | ----- | ----- | ----- |
| Pro forma limited partners' interest in net income (loss) | \$ 4,857 ===== | \$ 18,857 ===== | \$ (3, ===== |
| Weighted average limited partner units | 15,738,621 ===== | 13,223,184 ===== | 10,225, ===== |
| Basic net income (loss) per limited partner unit as reported | \$ 0.25 ===== | \$ 1.43 ===== | \$ (0 ===== |
| Basic net income (loss) per limited partner unit | | | |

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| | | | |
|---|------------|------------|---------|
| pro forma | \$ 0.31 | \$ 1.43 | \$ (0) |
| | ===== | ===== | ===== |
| Weighted average limited partner units, assuming dilutive effect of Phantom Units | 15,777,307 | 13,254,908 | 10,225, |
| | ===== | ===== | ===== |
| Diluted net income (loss) per limited partner unit as reported | \$ 0.25 | \$ 1.42 | \$ (0) |
| | ===== | ===== | ===== |
| Diluted net income (loss) per limited partner unit pro forma | \$ 0.31 | \$ 1.42 | \$ (0) |
| | ===== | ===== | ===== |

INCOME (LOSS) PER LIMITED PARTNER UNIT

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

F-17

| | Year Ended August 31, 2002 | Year Ended August 31, 2001 | Eigh Ended ----- 2000 (Unaudited) |
|---|----------------------------------|----------------------------------|---|
| BASIC NET INCOME (LOSS) PER LIMITED PARTNER UNIT: | | | |
| Limited partners' interest in net income (loss) | \$ 3,984 | \$ 18,879 | \$ (3,800) |
| | ===== | ===== | ===== |
| Weighted average limited partner units | 15,738,621 | 13,223,184 | 10,225,387 |
| | ===== | ===== | ===== |
| Basic net income (loss) per limited partner unit | \$ 0.25 | \$ 1.43 | \$ (0.37) |
| | ===== | ===== | ===== |

| | Year Ended August 31, 2002 | Year Ended August 31, 2001 | Eig Ende ----- 2000 |
|---|----------------------------------|----------------------------------|------------------------------|
| DILUTED NET INCOME (LOSS) PER LIMITED PARTNER UNIT: | | | |

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| | | | | | | |
|--|----|------------|----|------------|----|----------|
| Limited partners' interest in net income (loss) | \$ | 3,984 | \$ | 18,879 | \$ | (3,8 |
| | | ===== | | ===== | | ===== |
| Weighted average limited partner units | | 15,738,621 | | 13,223,184 | | 10,225,3 |
| Dilutive effect of Phantom Units | | 38,686 | | 31,724 | | |
| | | ----- | | ----- | | ----- |
| Weighted average limited partner units, assuming dilutive effect of Phantom Units | | 15,777,307 | | 13,254,908 | | 10,225,3 |
| | | ===== | | ===== | | ===== |
| Diluted net income (loss) per limited partner unit | \$ | 0.25 | \$ | 1.42 | \$ | (0. |
| | | ===== | | ===== | | ===== |

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of the more significant estimates made by management include, but are not limited to, allowances for doubtful accounts, derivative hedging instruments, liquids marketing assets and liabilities, and general business and medical self-insurance reserves. Actual results could differ from those estimates.

RECLASSIFICATIONS

Certain prior period amounts have been reclassified to conform with the 2002 presentation. These reclassifications have no impact on net income or net assets.

FAIR VALUE

The carrying amounts of accounts receivable and accounts payable approximate their fair value. Based on the estimated borrowing rates currently available to Heritage for long-term loans with similar terms and average maturities, the aggregate fair value and carrying amount of long-term debt at August 31, 2002 was \$470,264 and \$440,179, respectively. The fair value and carrying amount of long-term debt at August 31, 2001 was approximately \$465,690 and \$439,868, respectively.

SFAS 133 ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133). SFAS 133 requires that all derivatives be recognized in the balance sheet as either an asset or liability measured at fair value. Special accounting for qualifying hedges allows a derivative's gains and losses to offset related results on the hedged item in the statement of operations. Heritage adopted the provisions of SFAS 133 on September 1, 2000. The cumulative effect of adopting SFAS 133 was an adjustment to accumulated other comprehensive income of \$5,429.

Heritage had certain financial swap instruments that settled during the year ended August 31, 2002 that were designated as cash flow hedging instruments in accordance with SFAS 133. The swap instruments were contractual agreements to exchange obligations of money between the buyer and seller of the instruments as

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propane volumes during the pricing period are purchased. The swaps were tied to a set fixed price for the buyer and floating price determinants for the seller priced on certain indices at the end of the relevant trading period. Heritage entered into these instruments to hedge the forecasted propane volumes to be purchased during each of the one-month periods ending October 2001 through March 2002. Heritage utilized hedging transactions to provide price protection against significant fluctuations in propane prices. During the years ended August 31, 2002 and 2001, Heritage reclassified into earnings through cost of products sold, a loss of \$7,016 and a gain of \$3,844, respectively, that were previously reported in accumulated other comprehensive income (loss). There were no such financial instruments outstanding as of August 31, 2002.

SFAS 142 GOODWILL AND OTHER INTANGIBLE ASSETS

In June 2001, the FASB issued Statement No. 142, Goodwill and Other Intangible Assets (SFAS 142). Under SFAS 142, goodwill is no longer subject to amortization over its estimated useful life. Rather, goodwill will be subject to at least an annual assessment for impairment by applying a fair-value-based test. Additionally, any acquired intangible assets 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. Those assets will be amortized over their useful lives, other than assets that have an indefinite life.

Heritage adopted SFAS 142 on September 1, 2001 and accordingly has discontinued the amortization of goodwill. Under the provisions of SFAS 142, Heritage was required to perform a transitional goodwill impairment appraisal within six months from the time of adoption. Management engaged an independent appraisal firm to perform an assessment of the fair value of each of Heritage's operating segments, which were compared with the carrying value of each segment to determine whether any impairment existed on the date of adoption. Heritage has completed the transitional goodwill impairment appraisal and has determined that based on the fair value of Heritage's operating segments, Heritage's goodwill was not impaired as of September 1, 2001. Management has determined that a detailed evaluation of the Partnership's operating segments as of August 31, 2002 is not necessary based on the fact that there has not been a significant change in the components of the Partnership's operating segments since the last evaluation, the previous fair value of the Partnership's operating segments substantially exceeded the carrying value, and the likelihood that the Partnership's operating segments current carrying value exceeds its current fair value is remote based on an analysis of events and circumstances since the Partnership's most recent evaluation. Accordingly, no impairment of the Partnership's goodwill was recorded for the year ended August 31, 2002. The Partnership will continue to test goodwill for impairment as of the end of each fiscal year. The adoption of SFAS 142 eliminated goodwill amortization that would have totaled approximately \$5,704 for the year ended August 31, 2002, based on the balances of August 31, 2001, totaled approximately \$4,910 for the year ended August 31, 2001, and totaled \$308 for the eight months ended August 31, 2000. There was no goodwill amortization for the eight months ended August 31, 1999 or the year ended December 31, 1999.

The following table reflects the effect of the adoption of SFAS 142 on net income (loss) as if SFAS 142 had been in effect for all of the periods presented:

| Year Ended | Year Ended | Eight M |
|------------|------------|-----------|
| August 31, | August 31, | Ended Aug |
| 2002 | 2001 | ----- |
| | | 2000 |

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| | | | |
|--|----------|-----------|------------|
| | ----- | ----- | ----- |
| Net income (loss) as reported | \$ 4,902 | \$ 19,710 | \$ (3,846) |
| Add back: goodwill amortization | -- | 4,910 | 308 |
| | ----- | ----- | ----- |
| Adjusted net income (loss) | 4,902 | 24,620 | (3,538) |
| Adjusted General Partner's interest in net income (loss) | 918 | 880 | (43) |
| | ----- | ----- | ----- |
| Adjusted Limited Partners' interest in net income (loss) | \$ 3,984 | \$ 23,740 | \$ (3,495) |
| | ===== | ===== | ===== |
| | | | |
| Basic net income (loss) per limited partner unit | | | |
| As reported | \$ 0.25 | \$ 1.43 | \$ (0.37) |
| Goodwill amortization | \$ -- | \$ 0.37 | \$ 0.03 |
| As adjusted | \$ 0.25 | \$ 1.80 | \$ (0.34) |

F-19

| | | | |
|---|---------|---------|-----------|
| Diluted net income (loss) per limited partner unit: | | | |
| As reported | \$ 0.25 | \$ 1.42 | \$ (0.37) |
| Goodwill amortization | \$ -- | \$ 0.37 | \$ 0.03 |
| As adjusted | \$ 0.25 | \$ 1.79 | \$ (0.34) |

MARKETABLE SECURITIES

Heritage's marketable securities are classified as available-for-sale securities and are reflected as a current asset on the consolidated balance sheet at their fair value. Unrealized holding losses of \$1,575 and \$2,077 for the years ended August 31, 2002 and 2001, respectively, were recorded through accumulated other comprehensive income (loss) based on the market value of the securities. Management does not consider the decline in market value of the available-for-sale securities to be other than temporary.

LIQUIDS MARKETING ACTIVITIES

Heritage buys and sells derivative financial instruments which are within the scope of SFAS 133 and that are not designated as accounting hedges. Heritage also enters into energy trading contracts, which are not derivatives, and therefore are not within the scope of SFAS 133. EITF Issue No. 98-10, Accounting for Contracts Involved in Energy Trading and Risk Management Activities (EITF 98-10), applied to energy trading contracts not within the scope of SFAS 133 that were entered into prior to October 25, 2002. The types of contracts Heritage utilizes in its liquids marketing segment include energy commodity forward contracts, options, and swaps traded on the over-the-counter financial markets. In accordance with the provisions of SFAS 133, financial instruments utilized in connection with Heritage's liquids marketing activity are accounted for using the mark-to-market method. Additionally all energy trading contracts entered into prior to October 25, 2002 were accounted for using the mark-to-market method in accordance with provision of EITF 98-10. Under the mark-to-market method of accounting, forwards, swaps, options, and storage contracts are reflected at fair value, and are shown in the consolidated balance sheet as assets and liabilities from liquids marketing activities. As of August 31, 2002, Heritage adopted the applicable provisions of EITF Issue No. 02-3, Issues Related to Accounting for Contracts Involved in Energy Trading and

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Risk Management Activities (EITF 02-3), which requires that gains and losses on derivative instruments be shown net in the statement of operations if the derivative instruments are held for trading purposes. EITF 02-3 also specifies certain disclosure requirements. Net realized and unrealized gains and losses from the financial contracts and the impact of price movements are recognized in the statement of operations as liquids marketing revenue. Changes in the assets and liabilities from the liquids marketing activities result primarily from changes in the market prices, newly originated transactions, and the timing of settlement of contracts. EITF 02-03 also rescinds EITF 98-10 for all energy trading contracts entered into after October 25, 2002 and specifies certain disclosure requirements. Consequently, Heritage does not apply mark-to-market accounting for any contract entered into after October 25, 2002 that are not within the scope of SFAS 133. Heritage attempts to balance its contractual portfolio in terms of notional amounts and timing of performance and delivery obligations. However, net unbalanced positions can exist or are established based on management's assessment of anticipated market movements.

The adoption of EITF 02-3 requires that realized and unrealized gains and losses be shown net for all periods presented. The adoption of EITF 02-3 did not impact the eight months ended August 31, 1999 or the year ended December 31, 1999. The following table summarizes the amounts that have been reclassified in the statement of operations:

| | For the Years Ended August 31 , 2002 | 2001 | For the Eight Months Ended August 31, 2000 |
|--|---|------------|---|
| | ----- | ----- | ----- |
| Revenue - liquids marketing | \$ 159,607 | \$ 172,875 | \$ 12,262 |
| Revenue - other | -- | (556) | -- |
| Costs and expenses - liquids marketing | (159,065) | (171,478) | (11,538) |
| | ----- | ----- | ----- |
| Net, as reclassified | \$ 542 | \$ 841 | \$ 724 |
| | ===== | ===== | ===== |

F-20

The notional amounts and terms of these financial instruments as of August 31, 2002 and 2001 include fixed price payor for 1,180 and 2,130 barrels of propane, respectively, and fixed price receiver of 1,076 and 1,820 barrels of propane, respectively. Notional amounts reflect the volume of the transactions, but do not represent the amounts exchanged by the parties to the financial instruments. Accordingly, notional amounts do not accurately measure Heritage's exposure to market or credit risks.

The fair value of the financial instruments related to liquids marketing activities as of August 31, 2002 and 2001 was assets of \$2,301 and \$6,465, respectively, and liabilities of \$1,818 and \$7,130, respectively.

Estimates related to Heritage's liquids marketing activities are sensitive to uncertainty and volatility inherent in the energy commodities markets and actual results could differ from these estimates. A theoretical change of 10% in the

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underlying commodity value of the liquids marketing contracts would result in an approximate \$181 change in the market value of the contracts as there were approximately 4.3 million gallons of net unbalanced positions at August 31, 2002.

Inherent in the resulting contractual portfolio are certain business risks, including market risk and credit risk. Market risk is the risk that the value of the portfolio will change, either favorably or unfavorably, in response to changing market conditions. Credit risk is the risk of loss from nonperformance by suppliers, customers, or financial counterparties to a contract. Heritage takes active roles in managing and controlling market and credit risk and have established control procedures, which are reviewed on an ongoing basis. Heritage monitors market risk through a variety of techniques, including routine reporting to senior management. Heritage attempts to minimize credit risk exposure through credit policies and periodic monitoring procedures.

The following table summarizes the fair value of Heritage's' contracts, aggregated by method of estimating fair value of the contracts as of August 31, 2002, and 2001 where settlement had not yet occurred. Heritage's contracts all have a maturity of less than 1 year. The market prices used to value these transactions reflect management's best estimate considering various factors including closing average spot prices for the current and outer months plus a differential to consider time value and storage costs.

| Source of Fair Value | August 31, 2002 | August 31, 2001 |
|---|--------------------|--------------------|
| Prices actively quoted | \$1,276 | \$ 827 |
| Prices based on other valuation methods | 1,025 | 5,638 |
| | \$2,301 | \$6,465 |
| | ===== | ===== |
| Prices actively quoted | \$ 669 | \$1,297 |
| Prices based on other valuation methods | 1,149 | 5,833 |
| | \$1,818 | \$7,130 |
| | ===== | ===== |
| Unrealized gains (losses) | \$ 483 | \$ (665) |
| | ===== | ===== |

The following table summarizes the changes in the unrealized fair value of Heritage's contracts where settlement had not yet occurred for the fiscal years ended August 31, 2002 and 2001 and the 8-months ended August 31, 2000.

| | 2002 | 2001 | 2000 |
|---|----------|--------|-------|
| Unrealized gains (losses) in fair value of contracts outstanding at the beginning of the period | \$ (665) | \$ 591 | \$ -- |
| Unrealized gains (losses) recognized at inception of contracts | -- | -- | -- |

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| | | | |
|---|-------|-------|-------|
| Unrealized gains (losses) recognized as a result of changes in valuation techniques and assumptions | -- | -- | -- |
| Other unrealized gains (losses) recognized during the period | 1,207 | 250 | 724 |
| Less: Realized gains (losses) recognized during the period | 59 | 1,506 | 133 |
| | ----- | ----- | ----- |

F-21

| | | | |
|---|--------|----------|--------|
| Unrealized gains (losses) in fair value of contracts outstanding at the end of the period | \$ 483 | \$ (665) | \$ 591 |
| | ===== | ===== | ===== |

The following table summarizes the gross transaction volumes in barrels for liquids marketing contracts that were physically settled for the years ended August 31, 2002, 2001 and 2000:

(in thousands)

| | |
|-----------------------------------|-------|
| Fiscal year ended August 31, 2002 | 350 |
| Fiscal year ended August 31, 2001 | 1,193 |
| Fiscal year ended August 31, 2000 | -- |

RECENTLY ISSUED ACCOUNTING STANDARDS

In June 2001, the FASB issued Statement No. 143, Accounting for Asset Retirement Obligations (SFAS 143). SFAS 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. Heritage adopted the provisions of SFAS 143 on September 1, 2002. The adoption of SFAS 143 did not have a material impact on the Partnership's consolidated financial condition or results of operations.

In August 2001, the FASB issued Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144). SFAS 144 supersedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of (SFAS 121), and the accounting and reporting provisions of APB Opinion No. 30, Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions. SFAS 144 retains the fundamental provisions of SFAS 121 for recognition and measurement of the impairment of long-lived assets to be held and used, and measurement of long-lived assets to

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be disposed of by sale. SFAS 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001 and interim periods within those fiscal years, with early application encouraged. Heritage adopted the provisions of SFAS 144 on September 1, 2002. The adoption of SFAS 144 did not have a material impact on the Partnership's consolidated financial condition or results of operations.

In April 2002, the FASB issued Statement No. 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections (SFAS 145). SFAS 145 rescinds FASB Statement No. 4, Reporting Gains and Losses from Extinguishment of Debt, and an amendment of that Statement, FASB Statement No. 64, Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements. SFAS 145 also rescinds FASB Statement No. 44, Accounting for Intangible Assets of Motor Carriers, amends FASB Statement No. 13, Accounting for Leases, to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions and also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. SFAS 145 is effective for fiscal years beginning after May 15, 2002 with early application encouraged. Heritage adopted the provisions of SFAS 145 on September 1, 2002. The adoption did not have a material impact on the Partnership's consolidated financial condition or results of operations.

In December 2002, the FASB issued Statement No. 148 Accounting for Stock-Based Compensation - Transition and Disclosure (SFAS 148). The statement amends SFAS 123 to provide alternative methods of transitions for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The provisions of SFAS 148 are effective for fiscal years ending after July 31, 2003, with earlier application permitted, and the interim disclosure requirements of SFAS 148 are effective for periods beginning after December 15, 2002. Heritage adopted the fair value recognition provisions of SFAS 123 effective as of September 1, 2002. Under the modified prospective method of adoption selected by Heritage, the deferred compensation expense that will be recognized in fiscal 2003 will be the same as that which would have

F-22

been recognized had the fair value recognition provisions of SFAS 123 been applied to all awards granted under the Restricted Unit Plan and the Long Term Incentive Plan granted after its original effective date. Results from prior years have not been restated.

In October 2002, the EITF of the FASB discussed EITF Issue No. 02-3, Issues Related to Accounting for Contracts Involved in Energy Trading and Risk Management Activities (EITF 02-3). The EITF reached a consensus to rescind EITF Issue No. 98-10, Accounting for Contracts Involved in Energy Trading and Risk Management Activities (EITF 98-10), the impact of which is to preclude mark-to-market accounting for energy trading contracts not within the scope of SFAS 133. The EITF also reached a consensus that gains and losses on derivative instruments within the scope of SFAS 133 should be shown net in the statement of operations if the derivative instruments are held for trading purposes and what disclosure requirements should be. This consensus was effective for financial statements issued for periods ending after July 15, 2002. Heritage has adopted EITF 02-03 as of August 31, 2002, and upon application reclassified comparative

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financial statements for prior periods to conform to the consensus. This adoption did not have a material impact on Heritage's financial position or results of operations. The consensus regarding the rescission of EITF 98-10 is applicable for fiscal periods beginning after December 15, 2002. Energy trading contracts not within the scope of SFAS 133 purchased after October 25, 2002, but prior to the implementation of the consensus are not permitted to apply mark-to-market accounting. Management does not expect the adoption of EITF 02-3 as it relates to the rescission of EITF 98-10 to have a material affect on Heritage's financial position or results of operations.

In November 2002, the FASB issued Financial Interpretation No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" (FIN 45). FIN 45 expands the existing disclosure requirements for guarantees and requires that companies recognize a liability for guarantees issued after December 31, 2002. The implementation of FIN 45 did not have a significant impact on Heritage's financial position or results of operations.

In January 2003, the FASB issued Financial Interpretation No. 46 Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51 (FIN 46). FIN 46 clarifies Accounting Research Bulletin No. 51, Consolidated Financial Statements. If certain conditions are met, this interpretation requires the primary beneficiary to consolidate certain variable interest entities in which equity investors lack the characteristics of a controlling interest or do not have sufficient equity investment at risk to permit the variable interest entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for variable interest entities created or obtained after January 31, 2003. For variable interest entities acquired before February 1, 2003, the interpretation is effective for the first fiscal year or interim period beginning after June 15, 2003. Management does not believe FIN 46 will have a significant impact on the Partnership's financial position.

In June 2002, the FASB issued Statement No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146). SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and requires that a liability for a cost associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. Heritage adopted the provisions of SFAS 146 effective for exit or disposal activities that are initiated after December 31, 2002. The adoption did not have a material impact on the Partnership's consolidated financial position or results of operations.

In April 2003, the FASB issued Statement No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities (SFAS 149). SFAS 149 amends and clarifies financial accounting and reporting for derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under SFAS 133. SFAS 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. Heritage adopted SFAS 149 as of July 1, 2003. The adoption of SFAS 149 did not have a material impact on the Partnership's consolidated financial position or results of operations.

In May 2003, the FASB issued Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (SFAS 150). SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within the scope of SFAS 150 as a liability (or an asset in some circumstances). This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. Heritage adopted the provisions of SFAS 150 as of

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September 1, 2003. The adoption did not have a material impact on the Partnership's consolidated financial position or results of operations.

3. ACQUISITIONS

During the year ended August 31, 2002, Heritage purchased the stock of Virginia Gas Propane Company Inc., in Virginia, Mt Pleasant Propane, Inc. in Tennessee and two other smaller companies. Heritage also acquired substantially all of the assets of six companies, which included Tri-County Propane, Inc., located in North Carolina, Franconia Gas Corporation located in New Hampshire and Quality Gas, Inc. also located in North Carolina. The aggregate purchase price for these acquisitions totaled \$24,915, which included liabilities assumed and non-compete

F-23

agreements of \$5,173 for periods ranging from five to ten years. These acquisitions were financed primarily with the acquisition facility and were accounted for by the purchase method under SFAS 141. Heritage has historically accounted for business combinations using the purchase method; therefore, the guidelines of SFAS 141 did not have a significant impact on how the Partnership accounted for these acquisitions.

Heritage recorded the following intangible assets in conjunction with these acquisitions:

| | |
|--|----------|
| Customer lists (15 years) | \$ 1,066 |
| Non-compete agreements (5 to 10 years) | 2,800 |
| | ----- |
| Total amortized intangible assets | 3,866 |
| | |
| Trademarks and tradenames | 864 |
| Goodwill | 6,464 |
| Other assets | 96 |
| | ----- |
| Total intangible assets acquired | \$11,290 |
| | ===== |

Goodwill was warranted because these acquisitions enhance Heritage's current operations and certain acquisitions are expected to reduce costs through synergies with existing operations. Heritage assigned all of the goodwill acquired to the retail operating segment of the Partnership. The results of operations from these acquisitions are included on the Partnership's statement of operations from the dates acquired

On July 31, 2001, Heritage purchased the propane operations of ProFlame, Inc. and subsidiaries and affiliates (ProFlame) located in California and Nevada, in a series of mergers, stock purchases, and asset purchases. The aggregate purchase price was \$56,201 net of cash acquired of \$6,518. The purchase price included \$42,695 paid in cash, of which \$2,958 related to preliminary working capital, and liabilities assumed of \$9,056. In addition, a total of 158,917 Common Units valued at \$4,450 were payable in connection with the assumption of certain liabilities by Heritage Holdings. Although Heritage Holdings was entitled to 158,917 Common Units as a result of this transaction, it agreed to forego the issuance of 1,605 units and 1,638 units, which represented its capital contributions to maintain its 1% interest in the Partnership and its 1.0101% interest in the Operating Partnership, respectively, in relation to this transaction. Heritage Holdings also agreed to forego the issuance of an

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additional 25,773 Common Units to which it was entitled in the ProFlame acquisition to maintain its 1.0101% interest in the Operating Partnership as a result of the July 31, 2001 public offering. The Partnership issued 129,901 Common Units to Heritage Holdings with a fair value of \$28.00 per unit.

The results of operations of ProFlame are included in the consolidated statement of operations of Heritage for the year ended August 31, 2002.

The following unaudited pro forma consolidated results of operations are presented as if the series of transactions with ProFlame and Heritage had been made at the beginning of the period presented:

| | Year Ended August 31, 2001 | Eight Months Ended August 31, 2000 |
|--|-------------------------------|--|
| | ----- | ----- |
| Total revenues | \$595,317 | \$99,160 |
| Limited partners' interest in net income | \$ 19,492 | \$(5,938) |
| Basic and diluted net income per limited partner unit | \$ 1.47 | \$ (.55) |

The pro forma consolidated results of operations include adjustments to give effect to amortization of non-competes and customer lists, interest expense on acquisition and assumed debt, and certain other adjustments, including the elimination of income taxes. The unaudited pro forma information is not necessarily indicative of the results of operations that would have occurred had the transactions been made at the beginning of the period presented or the future results of the combined operations.

During 2001, Heritage purchased all of the common stock of EnergyNorth Propane, Inc. and its VGS Propane, LLC subsidiary in northern New England, and all of the stock of one other small company. Heritage acquired substantially all of the assets of seven other companies during the fiscal year ended August 31, 2001. These acquisitions totaled \$60,473, which included liabilities assumed and noncompete agreements of \$3,010 for periods

F-24

ranging up to ten years. These acquisitions were financed primarily with the acquisition facility and the issuance of 58,000 Common Units with a fair market value of \$1,600.

In August 2000, Heritage purchased substantially all of the assets of two companies for \$1,887 in cash and noncompete agreements with the prior owners for \$309. In January 2000, Peoples Gas purchased substantially all of the fixed assets of a company for approximately \$3,300 in cash and noncompete agreements with the prior owners for \$500.

4. WORKING CAPITAL FACILITY AND LONG-TERM DEBT:

Long-term debt consists of the following:

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| | August 31, 2002 ----- | August 31, 2001 ----- |
|---|-----------------------------|-----------------------------|
| 1996 8.55% Senior Secured Notes | \$108,000 | \$120,000 |
| 1997 Medium Term Note Program: | | |
| 7.17% Series A Senior Secured Notes | 12,000 | 12,000 |
| 7.26% Series B Senior Secured Notes | 20,000 | 20,000 |
| 6.50% Series C Senior Secured Notes | 2,857 | 3,571 |
| 6.59% Series D Senior Secured Notes | 4,444 | 5,000 |
| 6.67% Series E Senior Secured Notes | 5,000 | 5,000 |
| 2000 and 2001 Senior Secured Promissory Notes: | | |
| 8.47% Series A Senior Secured Notes | 16,000 | 16,000 |
| 8.55% Series B Senior Secured Notes | 32,000 | 32,000 |
| 8.59% Series C Senior Secured Notes | 27,000 | 27,000 |
| 8.67% Series D Senior Secured Notes | 58,000 | 58,000 |
| 8.75% Series E Senior Secured Notes | 7,000 | 7,000 |
| 8.87% Series F Senior Secured Notes | 40,000 | 40,000 |
| 7.21% Series G Senior Secured Notes | 26,500 | 26,500 |
| 7.89% Series H Senior Secured Notes | 27,500 | 27,500 |
| 7.99% Series I Senior Secured Notes | 16,000 | 16,000 |
| Senior Revolving Acquisition Facility | 14,000 | -- |
| Notes Payable on noncompete agreements with interest imputed at rates averaging 8%, due in installments through 2010, collateralized by a first security lien on certain assets of Heritage | 22,314 | 22,579 |
| Other | 1,564 | 1,718 |
| Current maturities of long-term debt | (20,158) | (16,120) |
| | ----- \$420,021 ===== | ----- \$423,748 ===== |

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

1996 8.55% Senior Secured Notes:

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

1997 Medium Term Note Program:

F-25

Series A Notes: mature at the rate of \$2,400 on November 19 in each of the years 2005 to and including

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2009. Interest is paid semi-annually.

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

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

Series D Notes: mature at the rate of \$556 on March 13 in each of the years 2002 to and including 2010. Interest is paid semi-annually.

Series E Notes: mature at the rate of \$714 on March 13 in each of the years 2007 to and including 2013. Interest is paid semi-annually.

2000 and 2001 Senior Secured Promissory Notes:

Series A Notes: mature at the rate of \$3,200 on August 15 in each of the years 2003 to and including 2007. Interest is paid quarterly.

Series B Notes: mature at the rate of \$4,571 on August 15 in each of the years 2004 to and including 2010. Interest is paid quarterly.

Series C Notes: mature at the rate of \$5,750 on August 15 in each of the years 2006 to and including 2007, \$4,000 on August 15, 2008 and \$5,750 on August 15, 2009 to and including 2010. Interest is paid quarterly.

Series D Notes: mature at the rate of \$12,450 on August 15 in each of the years 2008 and 2009, \$7,700 on August 15, 2010, \$12,450 on August 15, 2011 and \$12,950 on August 15, 2012. Interest is paid quarterly.

Series E Notes: mature at the rate of \$1,000 on August 15 in each of the years 2009 to and including 2015. Interest is paid quarterly.

Series F Notes: mature at the rate of \$3,636 on August 15 in each of the years 2010 to and including 2020. Interest is paid quarterly.

Series G Notes: mature at the rate of \$5,300 on May 15 in each of the years 2004 to and including 2008. Interest is paid quarterly.

Series H Notes: mature at the rate of \$2,500 on May 15 in each of the years 2006 to and including 2016. Interest is paid quarterly.

Series I Notes: mature in one payment of \$16,000 on May 15, 2013. Interest is paid quarterly.

The Note Agreements for each of the Notes, Medium Term Note Program and Senior Secured Promissory Notes, and the Bank Credit Facility contain customary restrictive covenants applicable to the Operating Partnership, including limitations on the level of additional indebtedness, creation of liens, and sale

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of assets. These covenants require the Operating Partnership to maintain ratios of Consolidated Funded Indebtedness to Consolidated EBITDA (as these terms are similarly defined in the Bank Credit Facility and the Note Agreements) of not more than 5.00 to 1 for the Bank Credit Facility and not more than 5.25 to 1 for the Note Agreements and Consolidated EBITDA to Consolidated Interest Expense (as these terms are similarly defined in the Bank Credit Facility and the Note Agreements) of not less than 2.25 to 1. The Consolidated EBITDA used to determine these ratios is calculated in accordance with these debt agreements. For purposes of calculating the ratios under the Bank Credit Facility and the Note Agreements, Consolidated EBITDA is based upon Heritage's EBITDA, as adjusted for the most recent four quarterly periods, and modified to give pro forma effect for acquisitions and divestitures made during the test period and is compared to Consolidated Funded Indebtedness as of the test date and the Consolidated Interest Expense for the most recent twelve months. These debt agreements also provide that the Operating Partnership may declare, make, or incur a liability to make, a restricted payment during each fiscal quarter, if: (a) the amount of such restricted payment, together with all other restricted payments during such quarter, do not exceed Available Cash with respect to the immediately preceding quarter; and (b) no default or event of default exists before such restricted payment and after giving effect thereto. The debt agreements further provide that Available Cash is required to reflect a reserve equal to 50% of the interest to be paid on the notes. In addition, in the third, second and first quarters preceding a quarter in which a scheduled principal payment is to be made on the notes, Available Cash is required to reflect a reserve equal to 25%, 50%, and 75%, respectively, of the principal amount to be repaid on such payment dates.

Failure to comply with the various restrictive and affirmative covenants of the Operating Partnership's Bank Credit Facility and the Note Agreements could negatively impact the Operating Partnership's ability to incur additional

F-26

debt and/or Heritage's ability to pay distributions. The Operating Partnership is required to measure these financial tests and covenants quarterly and was in compliance with all requirements, tests, limitations, and covenants related to the Notes, Medium Term Note Program and Senior Secured Promissory Notes, and the Bank Credit Facility at August 31, 2002.

Effective July 16, 2001, the Operating Partnership entered into the Fifth Amendment to the First Amended and Restated Credit Agreement. The terms of the Agreement as amended are as follows:

A \$65,000 Senior Revolving Working Capital Facility, expiring June 30, 2004 with \$30,200 outstanding at August 31, 2002. The interest rate and interest payment dates vary depending on the terms Heritage agrees to when the money is borrowed. Heritage must be free of all working capital borrowings for 30 consecutive days each fiscal year. The weighted average interest rate was 3.675% for the amount outstanding at August 31, 2002. The maximum commitment fee payable on the unused portion of the facility is 0.50%. All receivables, contracts, equipment, inventory, general intangibles, cash concentration accounts, and the capital stock of Heritage's subsidiaries secure the Senior Revolving Working Capital Facility.

A \$50,000 Senior Revolving Acquisition Facility is available through December 31, 2003, at which time the outstanding amount must be paid in ten equal quarterly installments beginning March 31, 2004, with \$14,000 outstanding as of August 31, 2002. The interest rate and interest payment dates vary depending on the terms Heritage agrees to when the money is

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borrowed. The weighted average interest rate was 3.675% for the amount outstanding at August 31, 2002. The maximum commitment fee payable on the unused portion of the facility is 0.50%. All receivables, contracts, equipment, inventory, general intangibles, cash concentration accounts, and the capital stock of Heritage's subsidiaries secure the Senior Revolving Acquisition Facility.

Future maturities of long-term debt for each of the next five fiscal years and thereafter are \$20,158 in 2003; \$33,399 in 2004; \$37,921 in 2005; \$47,811 in 2006; \$44,232 in 2007, and \$256,658 thereafter.

5. COMMITMENTS AND CONTINGENCIES:

Certain property and equipment is leased under noncancelable leases, which require fixed monthly rental payments and expire at various dates through 2020. Rental expense under these leases totaled approximately \$2,977 and \$2,708 for the years ended August 31, 2002 and August 31, 2001, respectively, \$245 for the eight months ended August 31, 2000, and \$184 for fiscal 1999 and has been included in operating expenses in the accompanying statements of operations. Certain of these leases contain renewal options and also contain escalation clauses, which are accounted for on a straight-line basis over the minimum lease term. Fiscal year future minimum lease commitments for such leases are \$2,864 in 2003; \$1,625 in 2004; \$1,274 in 2005; \$616 in 2006; \$422 in 2007 and \$714 thereafter.

The General Partner has entered into employment agreements with seven employees, (each an "Executive"). One of the Employment Agreements had an initial term of two years with an annual base salary of \$193 starting August 2000. At the expiration of the term on August 10, 2002, this Employment Agreement became "at will." The Employment Agreements for the other six Executives have an initial term of three years starting August 2000. However, for each Executive with a three year Employment Agreement, beginning on the second anniversary of the effective date and on each day thereafter, the expiration date shall be automatically extended one additional day unless either party (i) shall give written notice to the other that the Term shall cease to be so extended beginning immediately after the date of such notice or (ii) shall give a Notice of Termination to the other by delivering notice to the Chairman of the Board, or in the event of the employee's death. The Employment Agreements for the other six executives provide for an annual base salary of \$350, \$335, \$200, \$150, \$135, and \$135. The Employment Agreements provide for the Executives to participate in bonus and incentive plans.

The Employment Agreements provide that in the event of a change of control of the ownership of the General Partner or in the event an Executive (i) is involuntarily terminated (other than for "misconduct" or "disability") or (ii) voluntarily terminates employment for "good reason" (as defined in the agreements), such Executive will be entitled to continue receiving his base salary and to participate in all group health insurance plans and programs that may be offered to executives of the General Partner for the remainder of the term of the Employment Agreement or, if earlier, the Executive's death, and the Executive will vest immediately in the Minimum Award of the number of Common Units to which the Executive is entitled under the Long Term Incentive Plan to the extent not previously

F-27

awarded, and if the Executive is terminated as a result of the foregoing, all restrictions on the transferability of the units purchased by such executive under the Subscription Agreement dated as of June 15, 2000, shall automatically lapse in full on such date. If such change were to occur during fiscal year

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2003, the General Partner would be required to pay the remaining portion of \$1,305 in base salary for the six Executives whose employment agreements have the three-year terms and a maximum of 250,000 Common Units or approximately \$6,750 based on a per unit price of \$27.00 would be awarded under the Long Term Incentive Plan, of which \$1,500 and \$750 has been included in operating expenses in the accompanying statements of operations for the years ending August 31, 2002 and 2001, respectively. Each Employment Agreement also provides that if any payment received by an Executive is subject to the 20% federal excise tax under Section 4999(a) of the Code of the Internal Revenue Service, the payment will be grossed up to permit the Executive to retain a net amount on an after-tax basis equal to what he would have received had the excise tax and all other federal and state taxes on such additional amount not been payable. In addition, each Employment Agreement contains non-competition and confidentiality provisions.

Heritage is a party to various legal proceedings incidental to its business. Certain claims, suits and complaints arising in the ordinary course of business have been filed or are pending against Heritage. In the opinion of management, all such matters are either covered by insurance, are without merit or involve amounts, which, if resolved unfavorably, would not have a significant effect on the financial position or results of operations of Heritage. Once management determines that information pertaining to a legal proceeding indicates that it is probable that a liability has been incurred, an accrual is established equal to management's estimate of the likely exposure. For matters that are covered by insurance, the Partnership accrues the related deductible. As of August 31, 2002 and 2001, an accrual of \$671 and \$500, respectively, was recorded as accrued and other current liabilities on the Partnership's consolidated balance sheets.

Petroleum-based contamination or environmental wastes are known to be located on or adjacent to six sites, which Heritage presently or formerly had operations. These sites were evaluated at the time of their acquisition. In all cases, remediation operations have been or will be undertaken by others, and in all six cases, Heritage obtained indemnification for expenses associated with any remediation from the former owners or related entities. Heritage has not been named as a potentially responsible party at any of these sites, nor has the Partnership's operations contributed to the environmental issues at these sites. Accordingly, no amounts have been recorded in the Partnership's August 31, 2002 or 2001 consolidated balance sheet. Based on information currently available to Heritage, such projects are not expected to have a material adverse effect on Heritage's financial condition or results of operations.

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

Heritage has entered into several purchase and supply commitments with varying terms as to quantities and prices, which expire at various dates through March 2003.

6. PARTNERS' CAPITAL:

The Amended and Restated Agreement of Limited Partnership of Heritage Propane

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Partners, L.P. ("Partnership Agreement") contains specific provisions for the allocation of net earnings and losses to each of the partners for purposes of maintaining the partner capital accounts.

At the time of the Partnership's Initial Public Offering, Heritage Holdings held all of the Partnership's Subordinated Units. The Subordinated Units were a separate class of limited partner interests and the rights of holders of Subordinated Units to participate in distributions to partners differed from, and were subordinated to, the rights of the holders of Common Units.

F-28

Pursuant to the provisions of the Partnership Agreement relating to requirements that the Partnership meet specified cash performance and distribution requirements during successive four-quarter periods commencing with the Initial Public Offering in June of 1996, all of the Subordinated Units converted into Common Units and the Subordination Period ended. Under the Partnership Agreement, 925,736 Subordinated Units converted into Common Units as of July 7, 1999, 925,736 Subordinated Units converted into Common Units as of July 5, 2000 and the remaining 1,851,471 Subordinated Units converted into Common Units as of July 6, 2001. Common Units issued upon conversion of the Subordinated Units share equally with other Common Units in distributions of Available Cash.

Prior to February 4, 2002, the Partnership had Class B Subordinated Units representing limited partner interests that were issued to certain former stockholders of Heritage Holdings, who are or were also members of management, in connection with the transaction with U.S. Propane. The Class B Subordinated Units had the same voting rights as the Subordinated Units outstanding before the end of the Subordination Period, and generally participated pro rata with the Common Units in Heritage's income, gains, losses, deductions, credits, and distributions. Each Class B Subordinated Unit was entitled to one vote on each matter with respect to which the Class B Subordinated Units were entitled to vote.

On February 4, 2002, at the Special Meeting of the Common Unitholders of the Registrant, the Common Unitholders approved the amendment of the Partnership Agreement that converted all of the 1,382,514 outstanding Class B Subordinated Units into 1,382,514 Common Units. The Common Units issued upon conversion of the Class B Subordinated Units share equally with other Common Units in distributions of Available Cash.

In conjunction with the transaction with U.S. Propane and the change of control of the former General Partner, Heritage Holdings, the Partnership issued 1,000,000 newly created Class C Units to Heritage Holdings in conversion of that portion of its Incentive Distribution Rights that entitled it to receive any distribution made by Heritage attributable to the net amount received in connection with the settlement, judgment, award or other final nonappealable resolution of the SCANA litigation filed by Heritage prior to the transaction with U.S. Propane. The Class C Units have zero initial capital account balance and were distributed by Heritage Holdings to its former stockholders in connection with the transaction with U.S. Propane. Thus, U.S. Propane will not receive any distributions made with respect to the SCANA litigation that would have gone to Heritage Holdings with respect to its General Partner interest and Incentive Distribution Rights had it remained the General Partner of the Partnership. Upon receiving final cash payment as a result of the resolution of the SCANA litigation, the special litigation committee will determine the amount of litigation proceeds to be distributed, after deducting all costs and expenses of the litigation incurred by the Partnership and its affiliates and such reserves as the special committee deems necessary or advisable. The resulting amount of distributable proceeds will be distributed in the same manner as the

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Partnership's distribution of "Available Cash" pursuant to the Partnership Agreement, except that the amount that would normally be distributed to the holders of Incentive Distribution Rights will be distributed to the holders of Class C Units, pro rata. Each holder of Class C Units receiving a distribution of cash in any taxable year will be allocated items of gross income with respect to such taxable year in an amount equal to the cash distributed to the holder. Holders of Class C Units will not be allocated any other items of income, gain, loss deduction or credit and have no other rights except the right to share in any distributions upon dissolution and liquidation of the Partnership if such distributions consist of proceeds from the SCANA litigation and to which the Class C Units would have otherwise been entitled. The Class C Units may not be converted into any other unit. The Class C Units have no voting rights, except to the extent provided by Delaware law with respect to a vote as a class, in which case each Class C Unit will be entitled to one vote.

In conjunction with the Common Unitholder approval of the substitution of U.S. Propane as the General Partner of the Partnership, the Partnership issued 162,913 Common Units to the former General Partner Heritage Holdings in exchange for its 1.0101% general partner interest in the Operating Partnership. The Partnership also issued 158,026 Common Units to Heritage Holdings in conversion of its 1% general partner interest in the Partnership and cancelled 158,026 Common Units held by U.S. Propane upon their conversion into Incentive Distribution Rights and a 1% general partner interest in the Partnership and 1,646 Common Units held by U.S. Propane to maintain its general partner interest in the Partnership. The additional units are not registered with the Securities and Exchange Commission under the Securities Act of 1933, as amended, but are issued based upon an exemption from registration.

On September 1, 2001 and June 30, 2002, an additional 1,750 and 10,000 Common Units, respectively, were issued by the Partnership to holders of grants that had previously been awarded under the terms of the Partnership's Restricted Unit Plan.

F-29

On July 31, 2001, the Partnership sold 2,500,000 Common Units in an underwritten public offering at a price of \$28.00 per unit. Heritage used \$41 million of the approximate net proceeds of \$66 million to reduce indebtedness under the Senior Revolving Acquisition Facility, which was incurred in the acquisition of ProFlame. The remainder of the proceeds was used for general partnership purposes, including additional acquisitions and repayment of debt. To effect the transfer of the contribution required by the General Partner to maintain its 1% general partner interest in the Partnership, the General Partner contributed 25,252 Common Units to the Partnership and those units were cancelled.

On August 1, 2001, the Partnership issued 129,901 Common Units with a fair value of \$28.00 per unit to Heritage Holdings in connection with the assumption of certain liabilities by Heritage Holdings from Heritage's acquisition of certain assets of ProFlame. Heritage Holdings was entitled to 158,917 Common Units as a result of this transaction but agreed to forego the issuance of 1,605 units and 1,638 units, which represented its capital contributions to maintain its 1% interest in the Partnership and its 1.0101% interest in the Operating Partnership, respectively, in relation to this transaction. Heritage Holdings also agreed to forego the issuance of an additional 25,773 Common Units to which it was entitled in the ProFlame acquisition to maintain its 1.0101% interest in the Operating Partnership as a result of the July 31, 2001 public offering. These units were not registered with the Securities and Exchange Commission under the Securities Act of 1933, as amended, by virtue of an exemption under Section 4(2) thereof. These units carry a restrictive legend with regard to transfer of the units.

During fiscal 2001, the Partnership issued 58,000 Common Units in exchange for

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certain assets in connection with the acquisitions of certain propane businesses, for a total value of \$1.6 million. These units were issued utilizing the Partnership's Registration Statement No. 333-40407 on Form S-4.

QUARTERLY DISTRIBUTIONS OF AVAILABLE CASH

The Partnership Agreement requires that Heritage will distribute all of its Available Cash to its Unitholders and its General Partner within 45 days following the end of each fiscal quarter, subject to the payment of incentive distributions to the holders of Incentive Distribution Rights to the extent that certain target levels of cash distributions are achieved. The term Available Cash generally means, with respect to any fiscal quarter of the Partnership, all cash on hand at the end of such quarter, plus working capital borrowings after the end of the quarter, less reserves established by the General Partner in its sole discretion to provide for the proper conduct of Heritage's business, to comply with applicable laws or any Heritage debt instrument or other agreement, or to provide funds for future distributions to partners with respect to any one or more of the next four quarters. Available Cash is more fully defined in the Partnership Agreement.

Prior to the Unitholder vote on February 4, 2002, distributions by Heritage in an amount equal to 100% of Available Cash were made 97% to the common and Class B Subordinated Unitholders, 1.0101% to U.S. Propane for its limited partner interest in the Operating Partnership and 1.9899% to the former General Partner, Heritage Holdings. After the Unitholder vote, distributions by Heritage in an amount equal to 100% of Available Cash will generally be made 98% to the Common Unitholders and 2% to U.S. Propane, subject to the payment of incentive distributions to the holders of Incentive Distribution Rights to the extent that certain target levels of cash distributions are achieved.

The Minimum Quarterly Distribution was made to the Common and Subordinated Unitholders for the quarters ended November 30, 1996 through August 31, 1998. For the quarter ended November 30, 1998, a quarterly distribution of \$0.5125 was paid to the Common and Subordinated Unitholders. For each of the quarters ended February 28, 1999 through and including May 31, 2000, quarterly distributions of \$0.5625, respectively, were paid to the Common and Subordinated Unitholders. Heritage raised the quarterly distribution \$0.0125 per unit each quarter beginning with the quarter ended August 31, 2000, to \$0.6375 per unit (or \$2.55 annually) for the quarter ended November 30, 2001. The distribution remained at \$0.6375 per unit for each of the quarters ended February 28, 2002 through and including August 31, 2002. The quarterly distributions for the quarters ended February 28, 1999 through August 31, 2002 included incentive distributions payable to the General Partner to the extent the quarterly distribution exceeded \$0.55 per unit.

After the conversion of the Class B Subordinated Units was approved on February 4, 2002, each Class B Subordinated unit converted into one Common Unit and then participates pro rata with the other Common Units in distributions of Available Cash. Heritage currently distributes Available Cash, excluding any Available Cash to be distributed to the Class C Unitholders as follows:

F-30

- First, 98% to all Unitholders, pro rata, and 2% to the General Partner, until all Unitholders have received \$0.50 per unit for such quarter and any prior quarter;
- Second, 98% to all Unitholders, pro rata, and 2% to the General Partner, until all Unitholders have received \$0.55 per unit for such quarter;
- Third, 85% to all Unitholders, pro rata, 13% to the holders of

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Incentive Distribution Right, pro rata, and 2% to the General Partner, until all Common Unitholders have received at least \$0.635 per unit for such quarter;

- Fourth, 75% to all Unitholders, pro rata, 23% to the holders of Incentive Distribution Right, pro rata and 2% to the General Partner, until all Common Unitholders have received at least \$0.825 per unit for such quarter;
- Fifth, thereafter 50% to all Unitholders, pro rata, 48% to the holders of Incentive Distribution Right, pro rata, and 2% to the General Partner.

RESTRICTED UNIT PLAN

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

The issuance of the Common Units pursuant to the Restricted Unit Plan is intended to serve as a means of incentive compensation for performance and not primarily as an opportunity to participate in the equity appreciation in respect of the Common Units. Therefore, no consideration will be payable by the plan participants upon vesting and issuance of the Common Units. As of August 31, 2002, 26,900 restricted units are outstanding and 30,800 are available for grants to non-employee directors and key employees. Subsequent to August 31, 2002, 500 additional Phantom Units vested pursuant to the vesting rights of the Restricted Unit Plan and Common Units were issued.

During fiscal 2000, 21,300 of these Phantom Units were granted by Predecessor Heritage to non-employee directors and key employees of Predecessor Heritage. As of August 31, 2000, 80,800 Phantom Units were awarded of which 4,500 grants vested pursuant to the vesting rights of the Restricted Unit Plan and 71,300 vested in accordance with the change of control that occurred with U.S. Propane's acquisition of the capital stock of the former General Partner, Heritage Holdings. Individuals holding the remaining 5,000 grants waived their rights to vesting under the change of control and compensation cost related to such units will be recognized over the vesting period of the related awards. During fiscal 2002, 11,750 additional Phantom Units vested pursuant to the vesting rights of the Restricted Unit Plan and Common Units were issued, and 5,000 Phantom Units previously granted were forfeited. Heritage applied the provisions of APB 25 as of August 31, 2002. This plan is classified as a variable plan so that an estimate of compensation is required based on a combination of the fair market value of the Common Units as of the end of the

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reporting period and an assessment of meeting certain performance criteria. Deferred compensation expense of \$378 and \$323 was recognized for fiscal year 2002 and 2001, respectively on the units based on the fair value of such units at the end of each period.

LONG-TERM INCENTIVE PLAN

Effective September 1, 2000, Heritage adopted a long-term incentive plan whereby Common Units will be awarded based on achieving certain targeted levels of Distributed Cash (as defined in the Long Term Incentive Plan) per unit.

F-31

Awards under the program will be made starting in 2003 based upon the average of the prior three years' Distributed Cash per unit. A minimum of 250,000 Common Units and if certain targeted levels are achieved, a maximum of 500,000 Common Units will be awarded. Heritage applied the provisions of APB 25 as of August 31, 2002. The Long Term Incentive Plan is classified as a variable plan so that an estimate of compensation is required based on a combination of the fair market value of the Common Units as of the end of the reporting period and an assessment of meeting certain performance criteria. Deferred compensation expense on this plan of \$1,500 and \$756 was recognized for the years ended August 31, 2002 and 2001, respectively based on the fair value of such units at the end of each period. The expense was determined based on the Partnership achieving the minimum award available under the plan.

7. PROFIT SHARING AND 401(K) SAVINGS PLAN:

Heritage sponsors a defined contribution profit sharing and 401(k) savings plan (the "Plan"), which covers all employees subject to service period requirements. Contributions are made to the Plan at the discretion of the Board of Directors and are allocated to eligible employees as of the last day of the plan year based on their pro rata share of total contributions. Employer matching contributions are calculated using a discretionary formula based on employee contributions. Prior to 2001, employer-matching contributions were entirely discretionary. Heritage did not recognize any expense under the profit sharing provision of the Plan during the years ended August 31, 2002 or 2001, or the eight months ended August 31, 2000. Heritage made matching contributions of \$2,339, \$2,260, and \$0 to the 401(k) savings plan for the years ended August 31, 2002 and 2001, and the period ended August 31, 2000, respectively.

8. RELATED PARTY TRANSACTIONS:

Heritage has no employees and is managed by the General Partner. Pursuant to the Partnership Agreement, the General Partner is entitled to reimbursement for all direct and indirect expenses incurred or payments it makes on behalf of Heritage, and all other necessary or appropriate expenses allocable to Heritage or otherwise reasonably incurred by the General Partner in connection with operating Heritage's business. These costs, which totaled approximately \$95,749 for the year ended August 31, 2002 and \$93,442 for the year ended August 31, 2001, include compensation and benefits paid to officers and employees of the General Partner.

TECO performed certain services for Peoples Gas, which were billed at actual cost. In addition, common general and administrative salary and other operating costs and expenses were allocated to Peoples Gas based upon methods considered reasonable by management of TECO. Such charges for employee services amounted to \$1,836 and \$1,697 for the eight months ended August 31, 2000 and 1999, respectively, and \$2,906 for the year ended December 31, 1999.

Accounts payable to related companies include non-interest bearing amounts payable from Heritage to the General Partner of \$3,356 and \$6,360 as of August

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31, 2002 and 2001 respectively and interest bearing amounts payable of \$1,646 and \$1,577 to Bi-State Propane as of August 31, 2002 and 2001, respectively.

9. REPORTABLE SEGMENTS:

Heritage's financial statements reflect four reportable segments: the domestic retail operations of Heritage, the domestic wholesale operations of Heritage, the foreign wholesale operations of MP Energy Partnership, and the liquids marketing activities of Resources. Heritage's reportable domestic and wholesale fuel segments are strategic business units that sell products and services to different types of users: retail and wholesale customers. Intersegment sales by the foreign wholesale segment to the domestic segment are priced in accordance with the partnership agreement. Resources is a liquids marketing company that buys and sells financial instruments for its own account. Heritage manages these segments separately as each segment involves different distribution, sale and marketing strategies. Heritage evaluates the performance of its operating segments based on operating income, exclusive of selling, general, and administrative expenses of \$12,978 and \$15,716 for the years ended August 31, 2002 and 2001, respectively, and \$1,019 for the eight-month period ended August 31, 2000. Selling, general and administrative expenses, interest expense and other expenses are not allocated by segment. Investment in affiliates and equity in earnings (losses) of affiliates relates primarily to Heritage's investment in Bi-State Propane (see Note 10), and is part of the domestic retail fuel segment. The following table presents the unaudited financial information by segment for the following periods:

F-32

| | For the Years Ended August 31, | | For the Eight Months Ended August 31, | |
|--------------------------|-----------------------------------|------------|--|-------------|
| | 2002 | 2001 | 2000 | 1999 |
| | ---- | ---- | ---- | ---- |
| | | | | (Unaudited) |
| Gallons: | | | | |
| Domestic retail fuel | 329,574 | 330,242 | 38,268 | 22,118 |
| Domestic wholesale fuel | 16,798 | 12,741 | 562 | - |
| Foreign wholesale fuel | | | | |
| Affiliated | 67,265 | 86,166 | 5,118 | - |
| Unaffiliated | 65,309 | 88,882 | 6,245 | - |
| Elimination | (67,265) | (86,166) | (5,118) | - |
| | ----- | ----- | ----- | ----- |
| Total | 411,681 | 431,865 | 45,075 | 22,118 |
| | ===== | ===== | ===== | ===== |
| Revenues: | | | | |
| Domestic retail fuel | \$ 65,334 | \$ 440,527 | \$ 43,815 | \$ 21,766 |
| Domestic wholesale fuel | 9,956 | 9,902 | 415 | - |
| Foreign wholesale fuel | | | | |
| Affiliated | 33,561 | 55,798 | 3,132 | - |
| Unaffiliated | 31,248 | 49,977 | 3,392 | - |
| Elimination | (33,561) | (55,798) | (3,132) | - |
| Liquids marketing, net | 542 | 841 | 724 | - |
| Other domestic revenues | 55,245 | 42,728 | 3,188 | - |
| | ----- | ----- | ----- | ----- |
| Total | \$ 462,325 | \$ 543,975 | \$ 51,534 | \$ 21,766 |
| | ===== | ===== | ===== | ===== |
| Operating Income: | | | | |
| Domestic retail fuel | \$ 55,901 | \$ 69,416 | \$ (578) | \$ 2,666 |
| Domestic wholesale fuel | (3,940) | (1,163) | 17 | - |

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| | | | | |
|--------------------------------|-----------|-----------|----------|----------|
| Foreign wholesale fuel | | | | |
| Affiliated | 500 | 578 | - | - |
| Unaffiliated | 1,914 | 1,996 | 142 | - |
| Elimination | (500) | (578) | - | - |
| Liquids marketing | 64 | (110) | 724 | - |
| | ----- | ----- | ----- | ----- |
| Total | \$ 53,939 | \$ 70,139 | \$ 305 | \$ 2,666 |
| | ===== | ===== | ===== | ===== |
| Gain on Disposal of Assets: | | | | |
| Domestic retail fuel | 544 | 791 | 121 | - |
| Domestic wholesale fuel | 268 | 21 | - | - |
| Foreign wholesale fuel | | | | |
| Affiliated | - | - | - | - |
| Unaffiliated | - | - | - | - |
| Elimination | - | - | - | - |
| Liquids marketing | - | - | - | - |
| | ----- | ----- | ----- | ----- |
| Total | \$ 812 | \$ 812 | \$ 121 | \$ - |
| | ===== | ===== | ===== | ===== |
| Minority Interest Expense: | | | | |
| Corporate | 213 | 408 | (95) | - |
| Foreign wholesale | 361 | 406 | 15 | - |
| | ----- | ----- | ----- | ----- |
| Total | \$ 574 | \$ 814 | \$ (80) | \$ - |
| | ===== | ===== | ===== | ===== |
| Depreciation and amortization: | | | | |
| Domestic retail fuel | \$ 36,550 | \$ 40,135 | \$ 4,673 | \$ 2,037 |
| Domestic wholesale | 426 | 277 | 8 | - |
| Foreign wholesale | 22 | 19 | 5 | - |
| | ----- | ----- | ----- | ----- |
| Total | \$ 36,998 | \$ 40,431 | \$ 4,686 | \$ 2,037 |
| | ===== | ===== | ===== | ===== |

F-33

| | As of August 31, | |
|--|------------------|-----------|
| | 2002 | 2001 |
| | ---- | ---- |
| Total Assets: | | |
| Domestic retail | \$667,978 | \$682,906 |
| Domestic wholesale | 14,372 | 19,533 |
| Foreign wholesale | 10,564 | 8,467 |
| Liquids marketing | 6,919 | 35,127 |
| Corporate | 17,431 | 12,134 |
| | ----- | ----- |
| Total | \$717,264 | \$758,167 |
| | ===== | ===== |
| Additions to property, plant and equipment including acquisitions: | | |
| Domestic retail fuel | \$ 39,904 | \$ 78,597 |
| Domestic wholesale | - | 2,837 |
| Foreign wholesale | 46 | - |
| Corporate | 1,441 | 765 |
| | ----- | ----- |
| Total | \$ 41,391 | \$ 82,199 |
| | ===== | ===== |

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Corporate assets include vehicles, office equipment and computer software for the use of administrative personnel. These assets are not allocated to segments. Corporate minority interest expense relates to U.S. Propane's general partner interest in the Operating Partnership.

10. SIGNIFICANT INVESTEE:

Heritage holds a 50% interest in Bi-State Propane. Heritage accounts for its 50% interest in Bi-State Propane under the equity method. Heritage's investment in Bi-State Propane totaled \$7,485 and \$6,611 at August 31, 2002 and 2001, respectively. Heritage received distributions from Bi-State Propane of \$400 and \$125 for the years ended August 31, 2002 and 2001 respectively. On March 1, 2002, the Operating Partnership sold certain assets acquired in the ProFlame acquisition to Bi-State Propane for approximately \$9,730 plus working capital. There was no gain or loss recorded on the transaction. This sale was made pursuant to the provision in the Bi-State Propane partnership agreement that requires each partner to offer to sell any newly acquired businesses within Bi-State Propane's area of operations to Bi-State Propane. In conjunction with this sale, the Operating Partnership guaranteed \$5 million of debt incurred by Bi-State Propane to a financial institution. Based on the current financial condition of Bi-State Propane, Heritage considers the likelihood of the Partnership incurring a liability resulting from the guarantee to be remote. Heritage has not recorded a liability on the balance sheets as of August 31, 2002 or 2001 for this guarantee because the guarantee was in effect prior to the issuance of FIN 45, and there have been no amendments to the original guarantee.

Bi-State Propane's financial position is summarized below:

| | August 31, 2002 | August 31, 2001 |
|---------------------|--------------------|--------------------|
| | ----- | ----- |
| Current assets | \$ 3,321 | \$ 3,250 |
| Noncurrent assets | 23,105 | 14,008 |
| | ----- | ----- |
| | \$ 26,426 | \$ 17,258 |
| | ===== | ===== |
| Current liabilities | \$ 3,344 | \$ 2,454 |
| Long-term debt | 9,450 | 2,975 |
| Partners' capital: | | |
| Heritage | 7,485 | 6,611 |
| Other partner | 6,147 | 5,218 |
| | ----- | ----- |
| | \$ 26,426 | \$ 17,258 |
| | ===== | ===== |

Bi-State Propane's results of operations for the years ended August 31, 2002 and 2001, respectively are summarized below:

F-34

For the Years Ended
August 31,

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| | 2002 ---- | 2001 ---- |
|---------------|--------------|--------------|
| Revenues | \$ 16,815 | \$ 19,184 |
| Gross profit | 8,934 | 8,055 |
| Net income: | | |
| Heritage | 1,274 | 1,186 |
| Other Partner | 1,329 | 1,353 |

11. QUARTERLY FINANCIAL DATA (UNAUDITED):

Summarized unaudited quarterly financial data is presented below. The sum of net income (loss) per limited partner unit by quarter may not equal the net income (loss) per limited partner unit for the year due to variations in the weighted average units outstanding used in computing such amounts. Heritage's business is seasonal due to weather conditions in its service areas. Propane sales to residential and commercial customers are affected by winter heating season requirements, which generally results in higher operating revenues and net income during the period from October through March of each year and lower operating revenues and either net losses or lower net income during the period from April through September of each year. Sales to industrial and agricultural customers are much less weather sensitive.

| Fiscal 2002: | Quarter Ended ----- | | | |
|---|------------------------|----------------------|-----------------|--------------------|
| | November 30 ----- | February 28 ----- | May 31 ----- | August 31 ----- |
| Revenues | \$ 107,958 | \$ 184,002 | \$ 104,009 | \$ 69,311 |
| Gross Profit | 47,723 | 86,859 | 51,706 | 31,186 |
| Operating income (loss) | 3,870 | 39,138 | 4,434 | (1,186) |
| Net income (loss) | (4,779) | 30,130 | (4,319) | (1,353) |
| Basic and diluted net income (loss) per limited partner unit | \$ (0.32) | \$ 1.89 | \$ (0.28) | \$ (0.13) |

| Fiscal 2001: | Quarter Ended ----- | | | |
|---|------------------------|----------------------|-----------------|--------------------|
| | November 30 ----- | February 28 ----- | May 31 ----- | August 31 ----- |
| Revenues | \$ 118,055 | \$ 250,304 | \$ 106,134 | \$ 69,311 |
| Gross Profit | 48,116 | 111,598 | 46,299 | 31,186 |
| Operating income (loss) | 10,573 | 52,630 | 2,476 | (1,186) |
| Net income (loss) | 1,963 | 43,330 | (5,845) | (1,353) |
| Basic and diluted net income (loss) per limited partner unit | \$ 0.15 | \$ 3.30 | \$ (0.48) | \$ (0.13) |

12. SUBSEQUENT EVENTS:

On January 2, 2003, Heritage purchased the propane assets of V-1 Oil Co. ("V-1") of Idaho Falls, Idaho for total consideration of \$34.2 million after post-closing adjustments. The acquisition price was payable \$19.2 million in

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cash, with \$17.3 million of that amount financed by the Acquisition Facility, and by the issuance of 551,456 Common Units of Heritage valued at \$15.0 million. V-1's propane distribution network included 35 customer service locations in Colorado, Idaho, Montana, Oregon, Utah, Washington, and Wyoming.

F-35

On May 20, 2003, the Partnership sold 1,610,000 Common Units in an underwritten public offering at a public offering price of \$29.26 per unit. This sale included the exercise of the underwriters' over-allotment option to purchase an additional 210,000 Common Units. Heritage used approximately \$35.9 million of the \$44.8 million net proceeds from the sale of the Common Units to repay a portion of the indebtedness outstanding under various tranches of its Senior Secured Notes. The remainder of the proceeds was used for general partnership purposes, including repayment of additional debt. The Common Units were issued utilizing the Partnership's existing shelf registration statement on Form S-3. To effect the transfer of the contribution required by the General Partner to maintain its 1% general partner interest in the Partnership and its 1.0101% general partner interest in the Operating Partnership, the General Partner contributed 32,692 previously issued Common Units back to the Partnership and those units were cancelled.

On November 6, 2003, Heritage signed a definitive agreement with La Grange Energy, L.P. to purchase substantially all of its midstream natural gas assets by acquiring La Grange Energy, L.P.'s interests in its subsidiary, La Grange Acquisition, L.P. whose midstream operations are conducted under the name Energy Transfer Company, in exchange for approximately \$300 million in cash, repayment of outstanding indebtedness, and a combination of Partnership Common Units, Class D Units and Special Units. The transaction is valued at approximately \$980 million. The Partnership will also acquire the stock of Heritage Holdings, Inc., which owns approximately 4.4 million common units of the Partnership for \$100 million. La Grange Energy, L.P. will also purchase U.S. Propane, L.P., the General Partner of the Partnership, and U.S. Propane, L.L.C. from subsidiaries of AGL Resources, Atmos Energy Corporation, TECO Energy, Inc. and Piedmont Natural Gas Company, Inc.

F-36

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Partners of Heritage Propane Partners, L.P.:

We have audited the accompanying consolidated statements of operations, partners' capital and cash flows of Heritage Propane Partners, L.P. ("Predecessor Heritage" a Delaware limited partnership) and subsidiaries for the period ended August 9, 2000 and the year ended August 31, 1999. These financial statements are the responsibility of Predecessor Heritage's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present

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fairly, in all material respects, the results of operations and cash flows of Heritage Propane Partners, L.P. ("Predecessor Heritage") and subsidiaries for the period ended August 9, 2000, and the year ended August 31, 1999, in conformity with accounting principles generally accepted in the United States.

/s/ Arthur Andersen LLP

Tulsa, Oklahoma
 October 26, 2000
 (except with respect to
 the matter discussed in Note
 12, as to which the date is
 October 19, 2001)

The report of Arthur Andersen LLP shown above is a copy of a previously issued report; Arthur Andersen LLP has not reissued this report.

F-37

HERITAGE PROPANE PARTNERS, L.P. AND SUBSIDIARIES (PREDECESSOR)

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

| | For the Period Ended August 9, 2000 ----- |
|-------------------------------------|--|
| REVENUES: | |
| Retail fuel | \$ 178,906 |
| Wholesale fuel | 35,145 |
| Liquids marketing | 4,300 |
| Other | 24,140 |
| | ----- |
| Total revenues | 242,491 |
| | ----- |
| COSTS AND EXPENSES: | |
| Cost of products sold | 136,462 |
| Cost of liquids marketing | 4,283 |
| Operating expenses | 55,154 |
| Depreciation and amortization | 17,143 |
| Selling, general and administrative | 5,974 |
| | ----- |
| Total costs and expenses | 219,016 |
| | ----- |
| OPERATING INCOME | 23,475 |
| OTHER INCOME (EXPENSE): | |
| Interest expense | (17,664) |
| Equity in earnings of affiliates | 614 |
| Gain on disposal of assets | 514 |
| Other | (3) |
| | ----- |
| INCOME BEFORE MINORITY INTERESTS | 6,936 |
| Minority interests | (432) |
| | ----- |
| NET INCOME | 6,504 |
| GENERAL PARTNER'S INTEREST IN | |

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| | |
|---|-----------|
| NET INCOME | 65 |
| | ----- |
| LIMITED PARTNERS' INTEREST IN NET INCOME | \$ 6,439 |
| | ===== |
| BASIC NET INCOME PER LIMITED PARTNER UNIT | \$ 0.66 |
| | ===== |
| BASIC WEIGHTED AVERAGE NUMBER OF UNITS OUTSTANDING | 9,712,927 |
| | ===== |
| DILUTED NET INCOME PER LIMITED PARTNER UNIT | \$ 0.66 |
| | ===== |
| DILUTED WEIGHTED AVERAGE NUMBER OF UNITS OUTSTANDING | 9,788,093 |
| | ===== |

The accompanying notes are an integral part of this consolidated financial statement.

F-38

HERITAGE PROPANE PARTNERS, L.P. AND SUBSIDIARIES
(PREDECESSOR)

CONSOLIDATED STATEMENT OF PARTNERS' CAPITAL
(in thousands, except unit data)

| | Number of Units | | Common Unitholders | Subordinated Unitholders | Ge Pa |
|---|-----------------|--------------|-----------------------|-----------------------------|----------|
| | Common | Subordinated | | | |
| | ----- | ----- | ----- | ----- | ----- |
| BALANCE, AUGUST 31, 1999 | 5,825,674 | 2,777,207 | \$ 17,077 | \$ 1,809 | \$ |
| Unit distribution | -- | -- | (15,393) | (6,248) | |
| Issuance of Restricted Common Units | 184,030 | -- | 4,064 | -- | |
| Issuance of Common Units | 1,200,000 | -- | 24,054 | -- | |
| General Partner contribution | -- | -- | -- | -- | |
| Conversion of Subordinated Units | 925,736 | (925,736) | (1,480) | 1,480 | |
| Conversion of Phantom Units | 4,500 | -- | 29 | (28) | |
| Other | -- | -- | 283 | 75 | |
| Other comprehensive income - net gain on hedging instruments | -- | -- | -- | -- | |
| Net income | -- | -- | 5,246 | 1,193 | |
| | ----- | ----- | ----- | ----- | ----- |
| BALANCE, AUGUST 9, 2000 | 8,139,940 | 1,851,471 | \$ 33,880 | \$ (1,719) | \$ |
| | ===== | ===== | ===== | ===== | ===== |

The accompanying notes are an integral part of this consolidated financial statement.

F-39

HERITAGE PROPANE PARTNERS, L.P. AND SUBSIDIARIES
(PREDECESSOR)

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CONSOLIDATED STATEMENT OF CASH FLOWS
(in thousands)

| | For the Period Ended August 9, 2000 ----- |
|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | |
| Net income | \$ 6,504 |
| Reconciliation of net income to net cash provided by operating activities- | |
| Depreciation and amortization | 17,143 |
| Provision for losses on accounts receivable | 328 |
| Gain on disposal of assets | (514) |
| Deferred compensation on restricted units | 362 |
| Undistributed earnings of affiliates | (654) |
| Minority interests | 91 |
| Changes in assets and liabilities, net of effect of acquisitions: | |
| Accounts receivable | (7,138) |
| Inventories | (5,627) |
| Prepaid expenses | (541) |
| Intangibles and other assets | (851) |
| Accounts payable | 5,901 |
| Accrued and other current liabilities | (860) |
| | ----- |
| Net cash provided by operating activities | 14,144 |
| | ----- |
| CASH FLOWS FROM INVESTING ACTIVITIES: | |
| Cash paid for acquisitions, net of cash acquired | (46,801) |
| Capital expenditures | (12,931) |
| Proceeds from asset sales | 1,449 |
| | ----- |
| Net cash used in investing activities | (58,283) |
| | ----- |
| CASH FLOWS FROM FINANCING ACTIVITIES: | |
| Proceeds from borrowings | 159,070 |
| Principal payments on debt | (116,918) |
| Unit distribution | (21,897) |
| Net proceeds from issuance of Common Units | 24,054 |
| Capital contribution from General Partner | 278 |
| | ----- |
| Net cash provided by financing activities | 44,587 |
| | ----- |
| INCREASE IN CASH | 448 |
| CASH, beginning of period | 1,679 |
| | ----- |
| CASH, end of period | \$ 2,127 |
| | ===== |
| NONCASH FINANCING ACTIVITIES: | |
| Notes payable incurred on noncompete agreements | \$ 3,575 |
| | ===== |
| Issuance of restricted Common Units in connection with certain acquisitions | \$ 4,064 |
| | ===== |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | |
| Cash paid during the period for interest | \$ 18,377 |
| | ===== |

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Other comprehensive income

\$ 3,289

=====

The accompanying notes are an integral part of this consolidated financial statement.

F-40

HERITAGE PROPANE PARTNERS, L.P. AND SUBSIDIARIES (PREDECESSOR)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollar amounts in thousands, except unit and per unit data)

1. OPERATIONS AND ORGANIZATION:

Heritage Propane Partners, L.P. ("Predecessor Heritage") was formed April 24, 1996, as a Delaware limited partnership, to acquire, own and operate the propane business of Heritage Holdings, Inc. ("General Partner") In order to simplify Predecessor Heritage's obligation under the laws of several jurisdictions in which Predecessor Heritage conducts business, Predecessor Heritage's activities are conducted through a subsidiary operating partnership, Heritage Operating, L.P. (the "Operating Partnership"). Predecessor Heritage holds a 98.9899% limited partner interest and the General Partner holds a 1.0101% general partner interest in the Operating Partnership.

The Operating Partnership sells propane and propane-related products to approximately 286,000 retail customers in 27 states throughout the United States. Predecessor Heritage is also a wholesale propane supplier in the southwestern United States and in Canada, the latter through participation in MP Energy Partnership. MP Energy Partnership is a Canadian partnership primarily engaged in lower-margin wholesale distribution in which Predecessor Heritage owns a 60% interest. Predecessor Heritage grants credit to its customers for the purchase of propane and propane-related products.

In August 2000, U.S. Propane acquired all of the outstanding common stock of Heritage Holdings, Inc., ("General Partner"), the General Partner of Heritage Propane Partners, L.P. By virtue of Heritage Holdings, Inc.'s general partner and limited partner interests in Heritage Propane Partners, L.P., U.S. Propane gained control of Heritage Propane Partners, L.P. Simultaneously, U.S. Propane transferred its propane operations, consisting of its interest in four separate limited liability companies, AGL Propane, L.L.C., Peoples Gas Company, L.L.C., United Cities Propane Gas, L.L.C. and Retail Propane Company, L.L.C. (former Piedmont operations) to Heritage Propane Partners, L.P. for \$181,395 plus working capital. The \$181,395 was payable \$139,552 in cash, \$31,843 of assumed debt, and the issuance of 372,392 Common Units of Heritage Propane Partners, L.P. valued at \$7,348 and a 1.0101% limited partner interest in the Operating Partnership valued at \$2,652. The purchase price and the exchange price for the Common Units were approved by an independent committee of the Board of Directors of Heritage Holdings, Inc. The exchange price for the Common Units was \$19.73125 per unit under a formula based on the average closing price of the Heritage Propane Partners, L.P.'s Common Units on the New York Stock Exchange for the twenty (20) day period beginning ten (10) days prior to the public announcement of the transaction on June 15, 2000 (the "Formula Price"). The working capital adjustment is estimated at \$5,000 and is anticipated to be settled in December 2000.

Concurrent with the acquisition, Heritage Propane Partners, L.P. borrowed \$180,000 from several institutional investors and sold 1,161,814 Common Units and 1,382,514 Class B Subordinated Units in a private placement to the former

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shareholders of Heritage Holdings, Inc., based on the Formula Price, resulting in net proceeds of \$50,203. The total of these proceeds were utilized to finance the transaction and retire a portion of existing debt.

The merger was accounted for as a reverse acquisition in accordance with Accounting Principles Board Opinion No. 16. Although Heritage Propane Partners, L.P. is the surviving entity for legal purposes, U.S. Propane's propane operations will be the acquirer for accounting purposes. U.S. Propane retained the name Heritage Propane Partners, L.P. subsequent to the transactions ("Successor Heritage"). The assets and liabilities and results of operations of Predecessor Heritage are included in the financial statements of Successor Heritage as of August 10, 2000.

2. SIGNIFICANT ACCOUNTING POLICIES AND BALANCE SHEET DETAIL:

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of Predecessor Heritage, its subsidiaries, including the Operating Partnership, MP Energy Partnership, and Heritage Energy Resources, L.L.C. ("Resources"). Predecessor Heritage accounts for its 50% partnership interest in Bi-State Propane, another propane retailer, using the equity method. All significant intercompany transactions and accounts have been eliminated in consolidation. The

F-41

General Partner's 1.0101% interest in the Operating Partnership is accounted for in the consolidated financial statements as a minority interest.

REVENUE RECOGNITION

Sales of propane, propane appliances, parts and fittings are recognized at the time of delivery of the product to the customer or at the time of sale or installation. Revenue from service labor is recognized upon completion of the service and tank rent is recognized ratably over the period it is earned.

INCOME TAXES

Predecessor Heritage is a limited partnership. As a result, Predecessor Heritage's earnings or losses for federal income tax purposes are included in the tax returns of the individual partners. Accordingly, no recognition has been given to income taxes in the accompanying financial statements. Net earnings for financial statement purposes may differ significantly from taxable income reportable to Unitholders as a result of differences between the tax basis and financial reporting basis of assets and liabilities and the taxable income allocation requirements under the Partnership Agreement.

INCOME PER LIMITED PARTNER UNIT

Basic net income per limited partner unit is computed by dividing net income, after considering the General Partner's 1% interest, by the weighted average number of Common and Subordinated Units outstanding. Diluted net income per limited partner unit is computed by dividing net income, after considering the General Partner's 1% interest, by the weighted average number of Common and Subordinated Units outstanding and the weighted average number of restricted units ("Phantom Units") granted under the Restricted Unit Plan (see Note 5). A reconciliation of net income and weighted average units used in computing basic and diluted earnings per unit is as follows:

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| | Period Ended August 9, 2000 ----- |
|--|---|
| BASIC NET INCOME PER LIMITED PARTNER UNIT: | |
| Limited partners' interest in net income | \$ 6,439 ===== |
| Weighted average limited partner units | 9,712,927 ===== |
| Basic net income per limited partner unit | \$ 0.66 ===== |
| DILUTED NET INCOME PER LIMITED PARTNER UNIT: | |
| Limited partners' interest in net income | \$ 6,439 ===== |
| Weighted average limited partner units | 9,712,927 |
| Dilutive effect of Phantom Units | 75,166 ----- |
| Weighted average limited partner units, assuming dilutive effect of Phantom Units | 9,788,093 ===== |
| Diluted net income per limited partner unit | \$ 0.66 ===== |

USE OF ESTIMATES

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

3. ACQUISITIONS:

During the period ended August 9, 2000, Predecessor Heritage acquired certain assets of W. T. Johnson, Inc. in Yulee, FL, J & J Propane Gas, Inc. in various locations in Alabama and Tennessee; ServiGas with operations

F-42

located in Texas, New Mexico, and Arizona; Petro San Juan Leasing, Inc.; and two other small companies. Heritage Holdings, Inc. purchased all of the outstanding stock of Eaves Oil Company, Inc. of New Ellenton, SC; Blue Flame Gas Co. Inc. of Charleston, SC; Lake County Gas of Lower Lake, CA; Cumberland LP Gas, Inc. of Cookeville, TN; and one small company and conveyed the net assets to Predecessor Heritage. The acquisitions totaled \$54,904, which includes notes payable on noncompete agreements of \$3,575 for periods ranging from three to ten years and liabilities assumed. These acquisitions were financed primarily with the acquisition facility and the issuance of \$4,064 of Common Units.

The acquisitions have been accounted for by the purchase method and, accordingly, the purchase prices have been allocated to assets acquired and liabilities assumed based on the fair market values at the date of acquisitions. Predecessor Heritage capitalized as part of the purchase price allocation certain legal and other costs directly related to the acquisitions. The excess of the purchase price over the fair market values of the net assets acquired has been recorded as goodwill.

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The results of operations of the acquired entities have been included in the consolidated financial statements from the date of acquisition.

4. COMMITMENTS AND CONTINGENCIES:

Certain property and equipment is leased under noncancelable leases, which require fixed monthly rental payments and expire at various dates through 2008. Rental expense under these leases totaled approximately \$1,366 for the period ended August 9, 2000.

5. PARTNERS' CAPITAL:

The Agreement of Limited Partnership of Heritage Propane Partners, L.P. ("Partnership Agreement") contains specific provisions for the allocation of net earnings and loss to each of the partners for purposes of maintaining the partner capital accounts.

During the Subordination Period (as defined below), Predecessor Heritage may issue up to 2,012,500 additional Common Units (excluding Common Units issued in connection with conversion of Subordinated Units into Common Units) or an equivalent number of securities ranking on a parity with the Common Units and an unlimited number of partnership interests junior to the Common Units without a Unitholder vote. Predecessor Heritage may also issue additional Common Units during the Subordination Period in connection with certain acquisitions or the repayment of certain indebtedness. After the Subordination Period, the Partnership Agreement authorizes the General Partner to cause Predecessor Heritage to issue an unlimited number of limited partner interests of any type without the approval of any Unitholders. Pursuant to the terms of the Partnership Agreement, 925,736 Subordinated Units held by the General Partner converted to Common Units on July 7, 1999 and an additional 925,736 converted on July 5, 2000.

QUARTERLY DISTRIBUTIONS OF AVAILABLE CASH

Predecessor Heritage is expected to make quarterly cash distributions of all of its Available Cash, generally defined as consolidated cash receipts less consolidated operating expenses, debt service payments, maintenance capital expenditures and net changes in reserves established by the General Partner for future requirements. These reserves are retained to provide for the proper conduct of Predecessor Heritage's business, or to provide funds for distributions with respect to any one or more of the next four fiscal quarters.

Distributions by Predecessor Heritage in an amount equal to 100% of its Available Cash will generally be made 98% to the common and Subordinated Unitholders and 2% to the General Partner, subject to the payment of incentive distributions to the holders of Incentive Distribution Rights to the extent that certain target levels of cash distributions are achieved. To the extent there is sufficient Available Cash, the holders of Common Units have the right to receive the Minimum Quarterly Distribution (\$0.50 per Unit), plus any arrearages, prior to any distribution of Available Cash to the holders of Subordinated Units. Common Units will not accrue arrearages for any quarter after the Subordination Period and Subordinated Units will not accrue any arrearages with respect to distributions for any quarter.

F-43

In general, the Subordination Period will continue indefinitely until the first day of any quarter beginning after May 31, 2001, in which distributions of Available Cash equal or exceed the Minimum Quarterly Distribution ("MQD") on the Common Units and the Subordinated Units for each of the three consecutive

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four-quarter periods immediately preceding such date. Pursuant to the terms of the Partnership Agreement, 925,736 Subordinated Units held by the General Partner converted to Common Units on July 7, 1999, and an additional 925,736 converted on July 5, 2000. The conversion of these units was dependent on meeting certain cash performance and distribution requirements during the period that commenced with Predecessor Heritage's public offering in June of 1996. The subordination period applicable to the remaining Subordinated Units will end the first day of any quarter ending after May 31, 2001, in which certain cash performance and distribution requirements have been met. Upon expiration of the Subordination Period, all remaining Subordinated Units will convert to Common Units.

Predecessor Heritage is expected to make distributions of its Available Cash within 45 days after the end of each fiscal quarter ending November, February, May and August to holders of record on the applicable record date. A pro rata MQD of \$0.353 per common and Subordinated Unit was made on October 15, 1996 for the two-month period between Predecessor Heritage's initial public offering and the quarter ended August 31, 1996. The MQD was made to the common and Subordinated Unitholders for the quarters ended November 30, 1996 through August 31, 1998. For the quarter ended November 30, 1998, a quarterly distribution of \$0.5125 was paid to the common and Subordinated Unitholders. For each of the quarters ended February 28, 1999 through and including May 31, 2000, quarterly distributions of \$0.5625, respectively, were paid to the common and Subordinated Unitholders. The quarterly distributions for the quarters ended February 28, 1999 through May 31, 2000 included incentive distributions payable to the General Partner to the extent the quarterly distribution exceeded \$0.55 per unit.

RESTRICTED UNIT PLAN

The General Partner adopted a Restricted Unit Plan (the "Restricted Unit Plan") for its non-employee directors and key employees of the General Partner and its affiliates effective June 1996. Rights to acquire 146,000 Common Units ("Phantom Units") are available under the Restricted Unit Plan and may be granted to employees from time to time at the discretion of the Restricted Unit Plan Committee. Commencing on September 1, 1996 and on each September 1 thereafter that the Restricted Unit Plan is in effect, each director who is in office automatically receives 500 units. The Phantom Units vest upon, and in the same proportions as (1) the conversion of Predecessor Heritage's Subordinated Units into Common Units or if later, (2) the third anniversary of their grant date, and (3) terms and conditions specified by each grant. During fiscal 1999, 21,300 of these Phantom Units were granted to non-employee directors and key employees. During fiscal 1998, 20,200 of these Phantom Units were granted to non-employee directors and key employees. As of August 31, 1999, Phantom Units with a value of \$1,346 have been awarded and the compensation cost related to such units will be recognized over the vesting period of the related awards. Predecessor Heritage applies APB Opinion No. 25, Accounting for Stock Issued to Employees. Compensation cost and directors' fee expense of \$362 and \$358 was recorded for the period ended August 9, 2000 and fiscal 1999, respectively, related to the issuance of the units. Subsequent to August 31, 1999, 4,500 of Phantom Unit grants vested pursuant to the vesting rights of the Restricted Unit Plan. Predecessor Heritage follows the disclosure only provision of Statement of Financial Accounting Standards No. 123, Accounting for Stock-based Compensation ("SFAS 123"). Proforma net income and net income per limited partner unit under the fair value method of accounting for equity instruments under SFAS 123 would be the same as reported net income and net income per limited partner unit.

6. REGISTRATION STATEMENTS:

Effective November 19, 1997, Predecessor Heritage registered 2,000,000 additional Common Units on Form S-4 that may be issued from time to time by Predecessor Heritage by means of a prospectus delivered in connection with its

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negotiations for acquisition of other businesses, properties or securities in business combination transactions. During the period ended August 9, 2000, 76,152 Common Units were issued from this registration statement in connection with acquisitions.

Effective September 13, 1999, Predecessor Heritage registered \$150.0 million of Common Units and Debt Securities on Form S-3 that may be offered for sale in one or more offerings. On October 25, 1999, Predecessor Heritage issued a prospectus supplement offering 1,200,000 Common Units, representing limited partner interests in Predecessor Heritage. The underwriters delivered the Common Units to purchasers on October 28, 1999 at a public offering price of \$22.00 per Common unit. Predecessor Heritage used the net proceeds of approximately \$24.0

F-44

million from this offering to repay a portion of the outstanding indebtedness under its acquisition facility that was incurred to acquire propane businesses.

7. PROFIT SHARING AND 401(K) SAVINGS PLAN:

Predecessor Heritage sponsors a defined contribution profit sharing and 401(k) savings plan (the "Plan"), which covers all employees subject to service period requirements. Contributions are made to the Plan at the discretion of the Board of Directors. There was no expense under the profit sharing provision of the Plan during the period ended August 9, 2000.

8. RELATED PARTY TRANSACTIONS:

Predecessor Heritage has no employees and is managed by the General Partner. Pursuant to the Partnership Agreement, the General Partner is entitled to reimbursement for all direct and indirect expenses incurred or payments it makes on behalf of Predecessor Heritage, and all other necessary or appropriate expenses allocable to Predecessor Heritage or otherwise reasonably incurred by the General Partner in connection with operating Predecessor Heritage's business. These costs, which totaled approximately \$40,742 for the period ended August 9, 2000, include compensation and benefits paid to officers and employees of the General Partner.

9. REPORTABLE SEGMENTS:

Predecessor Heritage's financial statements reflect four reportable segments: the domestic retail operations of Predecessor Heritage, the domestic wholesale operations of Predecessor Heritage, the foreign wholesale operations of MP Energy Partnership, and the trading activities of Resources. Predecessor Heritage's reportable domestic and wholesale fuel segments are strategic business units that sell products and services to different types of users: retail and wholesale customers. Intersegment sales by the foreign wholesale segment to the domestic segment are priced in accordance with the partnership agreement. Resources is a trading company that buys and sells financial instruments for its own account. Predecessor Heritage manages these segments separately as each segment involves different distribution, sale and marketing strategies. Predecessor Heritage evaluates the performance of its operating segments based on operating income. The operating income below does not reflect domestic and foreign selling, general, and administrative expenses of \$5,974 for the period ended August 9, 2000.

The following table presents financial information by segment for the period ended August 9, 2000:

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August 9,
2000

Gallons:

| | |
|-------------------------|----------|
| Domestic retail fuel | 170,891 |
| Domestic wholesale fuel | 7,113 |
| Foreign wholesale fuel | |
| Affiliated | 63,390 |
| Unaffiliated | 75,514 |
| Elimination | (63,390) |
| | ----- |
| Total | 253,518 |
| | ===== |

Revenues:

| | |
|-------------------------|------------|
| Domestic retail fuel | \$ 178,906 |
| Domestic wholesale fuel | 4,342 |
| Foreign wholesale fuel | |
| Affiliated | 29,038 |
| Unaffiliated | 30,803 |
| Elimination | (29,038) |
| Liquids marketing | 4,300 |
| Other domestic revenues | 24,140 |
| | ----- |
| Total | \$ 242,491 |
| | ===== |

F-45

Operating Income:

| | |
|-------------------------|-----------|
| Domestic retail fuel | \$ 27,670 |
| Domestic wholesale fuel | 259 |
| Foreign wholesale fuel | |
| Affiliated | 541 |
| Unaffiliated | 1,528 |
| Elimination | (541) |
| Liquids marketing | (8) |
| | ----- |
| Total | \$ 29,449 |
| | ===== |

Depreciation and amortization:

| | |
|-------------------------|-----------|
| Domestic retail fuel | \$ 17,105 |
| Domestic wholesale fuel | 31 |
| Foreign wholesale fuel | 7 |
| | ----- |
| Total | \$ 17,143 |
| | ===== |

10. SIGNIFICANT INVESTEE:

At August 9, 2000, Predecessor Heritage held a 50% interest in Bi-State Propane. Predecessor Heritage accounts for its 50% interest in Bi-State Propane under the equity method. Predecessor Heritage received distributions from Bi-State Propane in the amount of \$200 for the period ended August 9, 2000.

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Bi-State Propane's results of operations for the period ended August 9, 2000 is summarized below:

| | | | |
|---------------|--|----|--------|
| Revenues | | \$ | 12,298 |
| Gross profit | | | 6,008 |
| Net income: | | | |
| Heritage | | | 613 |
| Other partner | | | 753 |

11. QUARTERLY FINANCIAL DATA (UNAUDITED):

The retail propane distribution business is largely seasonal due to propane's use as a heating source in residential and commercial buildings. Historically, approximately two-thirds of Predecessor Heritage's retail propane volume and more than 80% of the EBITDA, as adjusted is attributable to sales during the six-month peak-heating season of October through March. Consequently, sales and operating profits are concentrated in Predecessor Heritage's first and second fiscal quarters. Cash flow from operations, however, is greatest during the second and third fiscal quarters when customers pay for propane purchased during the six-month peak-heating season.

| Fiscal 2000: | Quarter Ended | | | Period Ended |
|--|---------------|-------------|-----------|--------------|
| | November 30 | February 28 | May 31 | August 9, |
| Revenues | \$ 51,890 | \$102,160 | \$ 57,224 | \$ 31,217 |
| Operating income (loss) | 3,430 | 21,253 | 2,732 | (3,940) |
| Net income (loss) | (808) | 16,971 | (2,198) | (7,461) |
| Net income (loss) per unit- basic and diluted | (0.09) | 1.70 | (0.22) | (0.72) |

F-46

12. SUBSEQUENT EVENT:

On August 22, 2001, the final payment to settle the working capital adjustment was made to the partners of U.S. Propane. Total payments made to settle the working capital adjustment were approximately \$12,900. Accordingly, an additional amount of approximately \$7,900 was recorded as goodwill (See Note 1).

F-47

The exhibits listed on the following Exhibit Index are filed as part of this report. Exhibits required by Item 601 of Regulation S-K, but which are not listed below, are not applicable.

| Exhibit Number | Description |
|-------------------|-------------|
|-------------------|-------------|

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| | | | |
|------|--------|--|-------|
| | ----- | | ----- |
| (1) | 3.1 | Agreement of Limited Partnership of Heritage Propane Partners, L.P. | |
| (10) | 3.1.1 | Amendment No. 1 to Amended and Restated Agreement of Limited Partnership | |
| (16) | 3.1.2 | Amendment No. 2 to Amended and Restated Agreement of Limited Partnership | |
| (19) | 3.1.3 | Amendment No. 3 to Amended and Restated Agreement of Limited Partnership | |
| (19) | 3.1.4 | Amendment No. 4 to Amended and Restated Agreement of Limited Partnership | |
| (1) | 3.2 | Agreement of Limited Partnership of Heritage Operating, L.P. | |
| (12) | 3.2.1 | Amendment No. 1 to Amended and Restated Agreement of Limited Partnership | |
| (19) | 3.2.2 | Amendment No. 2 to Amended and Restated Agreement of Limited Partnership | |
| (18) | 3.3 | Amended Certificate of Limited Partnership of Heritage Propane Partners, | |
| (18) | 3.4 | Amended Certificate of Limited Partnership of Heritage Operating, L.P. | |
| (20) | 4.1 | Registration Rights Agreement for Limited Partner Interests of Heritage | |
| (7) | 10.1 | First Amended and Restated Credit Agreement with Banks Dated May 31, 199 | |
| (8) | 10.1.1 | First Amendment to the First Amended and Restated Credit Agreement dated | |
| (9) | 10.1.2 | Second Amendment to First Amended and Restated Credit Agreement dated as | |
| (10) | 10.1.3 | Third Amendment dated as of August 10, 2000 to First Amended and Restate | |
| (13) | 10.1.4 | Fourth Amendment to First Amended and Restated Credit Agreement dated as | |
| (16) | 10.1.5 | Fifth Amendment to First Amended and Restated Credit Agreement dated as | |
| (1) | 10.2 | Form of Note Purchase Agreement (June 25, 1996) | |

E-1

| | Exhibit Number | Description |
|------|-------------------|--|
| | ----- | ----- |
| (3) | 10.2.1 | Amendment of Note Purchase Agreement (June 25, 1996) dated as of July 25 |
| (4) | 10.2.2 | Amendment of Note Purchase Agreement (June 25, 1996) dated as of March 1 |
| (6) | 10.2.3 | Amendment of Note Purchase Agreement (June 25, 1996) dated as of October |
| (8) | 10.2.4 | Second Amendment Agreement dated September 1, 1999 to June 25, 1996 Note |
| (11) | 10.2.5 | Third Amendment Agreement dated May 31, 2000 to June 25, 1996 Note Purch 1997 Note Purchase Agreement |
| (10) | 10.2.6 | Fourth Amendment Agreement dated August 10, 2000 to June 25, 1996 Note P 19, 1997 Note Purchase Agreement |
| (13) | 10.2.7 | Fifth Amendment Agreement dated as of December 28, 2000 to June 25, 1996 |

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| | | |
|------|---------|--|
| | | November 19, 1997 Note Purchase Agreement and August 10, 2000 Note Purchase |
| (1) | 10.3 | Form of Contribution, Conveyance and Assumption Agreement among Heritage Propane Partners, L.P. and Heritage Operating, L.P. |
| (1) | 10.6 | Restricted Unit Plan |
| (4) | 10.6.1 | Amendment of Restricted Unit Plan dated as of October 17, 1996 |
| (12) | 10.6.2 | Amended and Restated Restricted Unit Plan dated as of August 10, 2000 |
| (18) | 10.6.3 | Second Amended and Restated Restricted Unit Plan dated as of February 4, |
| (12) | 10.7 | Employment Agreement for James E. Bertelsmeyer dated as of August 10, 20 |
| (18) | 10.7.1 | Consent to Assignment of Employment Agreement for James E. Bertelsmeyer |
| (**) | 10.7.2 | Amendment 1 of Employment Agreement for James E. Bertelsmeyer dated Augu |
| (12) | 10.8 | Employment Agreement for R. C. Mills dated as of August 10, 2000 |
| (18) | 10.8.1 | Consent to Assignment of Employment Agreement for R.C. Mills dated Febru |
| (12) | 10.9 | Employment Agreement for Larry J. Dagley dated as of August 10, 2000 |
| (18) | 10.9.1 | Consent to Assignment of Employment Agreement for Larry J. Dagley dated |
| (12) | 10.10 | Employment Agreement for H. Michael Krimbill dated as of August 10, 2000 |
| (18) | 10.10.1 | Consent to Assignment of Employment Agreement for H. Michael Krimbill da |
| (12) | 10.11 | Employment Agreement for Bradley K. Atkinson dated as of August 10, 2000 |

E-2

| | Exhibit Number ----- | Description ----- |
|------|----------------------------|--|
| (18) | 10.11.1 | Consent to Assignment of Employment Agreement for Bradley K. Atkinson da |
| (7) | 10.12 | First Amended and Restated Revolving Credit Agreement between Heritage S Corp. and Banks Dated May 31, 1999 |
| (16) | 10.12.1 | First Amendment to First Amended and Restated Revolving Credit Agreement |
| (16) | 10.12.2 | Second Amendment to First Amended and Restated Revolving Credit Agreemen |
| (16) | 10.12.3 | Third Amendment to First Amended and Restated Revolving Credit Agreement |
| (16) | 10.12.4 | Fourth Amendment to First Amended and Restated Revolving Credit Agreemen |
| (12) | 10.13 | Employment Agreement for Mark A. Darr dated as of August 10, 2000 |
| (18) | 10.13.1 | Consent to Assignment of Employment Agreement for Mark A. Darr dated Feb |
| (12) | 10.14 | Employment Agreement for Thomas H. Rose dated as of August 10, 2000 |
| (18) | 10.14.1 | Consent to Assignment of Employment Agreement for Thomas H. Rose dated F |

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- (12) 10.15 Employment Agreement for Curtis L. Weishahn dated as of August 10, 2000
- (18) 10.15.1 Consent to Assignment of Employment Agreement for Curtis L. Weishahn dated as of August 10, 2000
- (5) 10.16 Note Purchase Agreement dated as of November 19, 1997
- (6) 10.16.1 Amendment dated October 15, 1998 to November 19, 1997 Note Purchase Agreement
- (8) 10.16.2 Second Amendment Agreement dated September 1, 1999 to November 19, 1997 Note Purchase Agreement and August 10, 1996 Note Purchase Agreement
- (9) 10.16.3 Third Amendment Agreement dated May 31, 2000 to November 19, 1997 Note Purchase Agreement and August 10, 1996 Note Purchase Agreement
- (10) 10.16.4 Fourth Amendment Agreement dated August 10, 2000 to November 19, 1997 Note Purchase Agreement and August 10, 1996 Note Purchase Agreement
- (13) 10.16.5 Fifth Amendment Agreement dated as of December 28, 2000 to June 25, 1996 Note Purchase Agreement and August 10, 2000 Note Purchase Agreement and November 19, 1997 Note Purchase Agreement
- (10) 10.17 Contribution Agreement dated June 15, 2000 among U.S. Propane, L.P., Heritage Propane Partners, L.P.
- (10) 10.17.1 Amendment dated August 10, 2000 to June 15, 2000 Contribution Agreement

E-3

- | Exhibit
Number
----- | Description
----- |
|----------------------------|---|
| (10) 10.18 | Subscription Agreement dated June 15, 2000 between Heritage Propane Partners, L.P. and U.S. Propane, L.P. |
| (10) 10.18.1 | Amendment dated August 10, 2000 to June 15, 2000 Subscription Agreement |
| (16) 10.18.2 | Amendment Agreement dated January 3, 2001 to the June 15, 2000 Subscription Agreement |
| (17) 10.18.3 | Amendment Agreement dated October 5, 2001 to the June 15, 2000 Subscription Agreement. |
| (10) 10.19 | Note Purchase Agreement dated as of August 10, 2000 |
| (13) 10.19.1 | Fifth Amendment Agreement dated as of December 28, 2000 to June 25, 1996 Note Purchase Agreement and August 10, 2000 Note Purchase Agreement and November 19, 1997 Note Purchase Agreement |
| (14) 10.19.2 | First Supplemental Note Purchase Agreement dated as of May 24, 2001 to the August 10, 2000 Note Purchase Agreement |
| (15) 10.20 | Stock Purchase Agreement dated as of July 5, 2001 among the shareholders of Heritage Propane Partners, L.P. and Heritage Holdings, Inc. |
| (15) 10.21 | Stock Purchase Agreement dated as of July 5, 2001 among the shareholders of Heritage Propane Partners, L.P. and Heritage Holdings, Inc. |
| (15) 10.22 | Agreement and Plan of Merger dated as of July 5, 2001 among California Western Gas Company, California Western Gas Company Stockholders of California Western Gas Company signatories thereto, Heritage Propane Partners, L.P., Heritage Propane Partners, L.P. and California Western Merger Corp. |

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| | | |
|------|---------|---|
| (15) | 10.23 | Agreement and Plan of Merger dated as of July 5, 2001 among Growth Properties thereto, Heritage Holdings, Inc. and Growth Properties Merge |
| (15) | 10.24 | Asset Purchase Agreement dated as of July 5, 2001 among L.P.G. Associates Associates and Heritage Operating, L.P. |
| (15) | 10.25 | Asset Purchase Agreement dated as of July 5, 2001 among WMJB, Inc., the Heritage Operating, L.P. |
| (15) | 10.25.1 | Amendment to Asset Purchase Agreement dated as of July 5, 2001 among WMJB, Inc. and Heritage Operating, L.P. |
| (18) | 10.26 | Assignment, Conveyance and Assumption Agreement between U.S. Propane, L.P. as the former General Partner of Heritage Propane Partners, L.P. dated as of |
| (18) | 10.27 | Assignment, Conveyance and Assumption Agreement between U.S. Propane, L.P. as the former General Partner of Heritage Operating, L.P., dated as of |
| (**) | 21.1 | List of Subsidiaries |
| (*) | 23.3 | Consent of Grant Thornton LLP |

E-4

| | Exhibit Number ----- | Description ----- |
|------|----------------------------|---|
| (*) | 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the |
| (*) | 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the |
| (*) | 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1348 Section 906 of the Sarbanes-Oxley Act of 2002. |
| (*) | 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1348 Section 906 of the Sarbanes-Oxley Act of 2002. |
| (*) | 99.1 | Financial Statements of U.S. Propane, L.P. as of August 31, 2002 |
| (**) | 99.2 | Financial Statements of Bi-State Propane Partnership |

-
- (1) Incorporated by reference to the same numbered Exhibit to Registrant's Registration Statement of Form S-1, File No. 333-04018, filed with the Commission on June 21, 1996.
 - (2) Incorporated by reference to Exhibit 10.11 to Registrant's Registration Statement on Form S-1, File No. 333-04018, filed with the Commission on June 21, 1996.
 - (3) Incorporated by reference to the same numbered Exhibit to Registrant's Form 10-Q for the quarter ended November 30, 1996.
 - (4) Incorporated by reference to the same numbered Exhibit to Registrant's Form 10-Q for the quarter ended February 28, 1997.

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- (5) Incorporated by reference to the same numbered Exhibit to Registrant's Form 10-Q for the quarter ended May 31, 1998.
- (6) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 10-K for the year ended August 31, 1998.
- (7) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 10-Q for the quarter ended May 31, 1999.
- (8) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 10-K for the year ended August 31, 1999.
- (9) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 10-Q for the quarter ended May 31, 2000.
- (10) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 8-K dated August 23, 2000.
- (11) File as Exhibit 10.16.3.
- (12) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 10-K for the year ended August 31, 2000.

E-5

- (13) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 10-Q for the quarter ended February 28, 2001.
- (14) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 10-Q for the quarter ended May 31, 2001.
- (15) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 8-K dated August 15, 2001.
- (16) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 10-K for the year ended August 31, 2001.
- (17) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 10-Q for the quarter ended November 30, 2001.
- (18) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 10-Q for the quarter ended February 28, 2002.
- (19) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 10-Q for the quarter ended May 31, 2002.
- (20) Incorporated by reference to the same numbered Exhibit to the Registrant's Form 8-K dated February 4, 2002.
- (*) Filed herewith.
- (**) Filed with the November 27, 2002 Original Filing.

E-6