

## Meter Reader

*A Weekly Analysis of Energy Stocks Using the McDep Ratio*

October 26, 2004

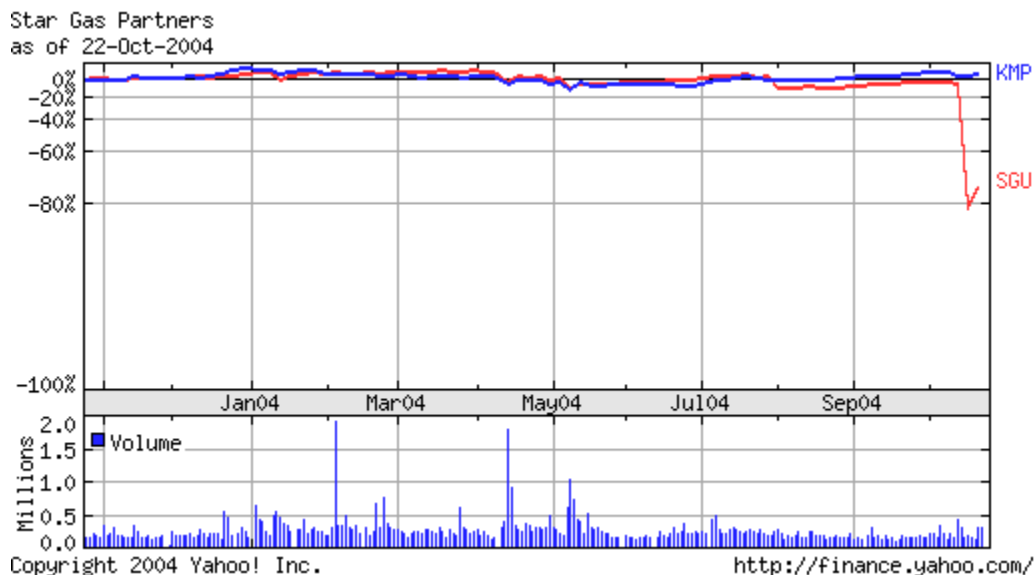
# Fallen Star

## Summary and Recommendation

The 80% collapse in stock price for Star Gas Partners LP (SGU) last week attests to the unrecognized risks we see in sell-recommended **Kinder Morgan Energy Partners (KMP)**, **Kinder Morgan Management LLC (KMR)** and **Kinder Morgan Inc. (KMI)**. A highly-leveraged, downstream energy partnership with potentially explosive general partner compensation, Star imploded despite having the active participation of a well-known director, Mr. Thomas Edelman. Only a few months ago the partnership that bills itself as the nation's largest retail distributor of home heating oil enjoyed Wall Street and investor support in an underwriting of new common units. Adding to the risks exposed by Star, Kinder Morgan, in our opinion, understates debt, overstates earnings and compensates the general partner excessively without fully disclosing the negative impact.

## Stock Price and Income Nightmare

SGU stock traded in a stable pattern and then dropped 80% instantly (see chart). For comparison purposes we note that that the stock price pattern leading up to the collapse was nearly indistinguishable from KMP, for example.



The drop in unit price coincides with the suspension of the distribution. One week income investors thought they were getting a \$2.30 per unit annual distribution, the next week their income vaporized.

Historical independent energy investment analysis by Kurt Wulff doing business as McDep Associates is posted at [www.mcdep.com](http://www.mcdep.com). Analyses are prepared from sources and data believed to be reliable, but no representation is made as to their accuracy or completeness. Mr. Wulff is not paid by covered companies. Neither he nor his spouse trade a subject stock within a week before or after a change in rating.

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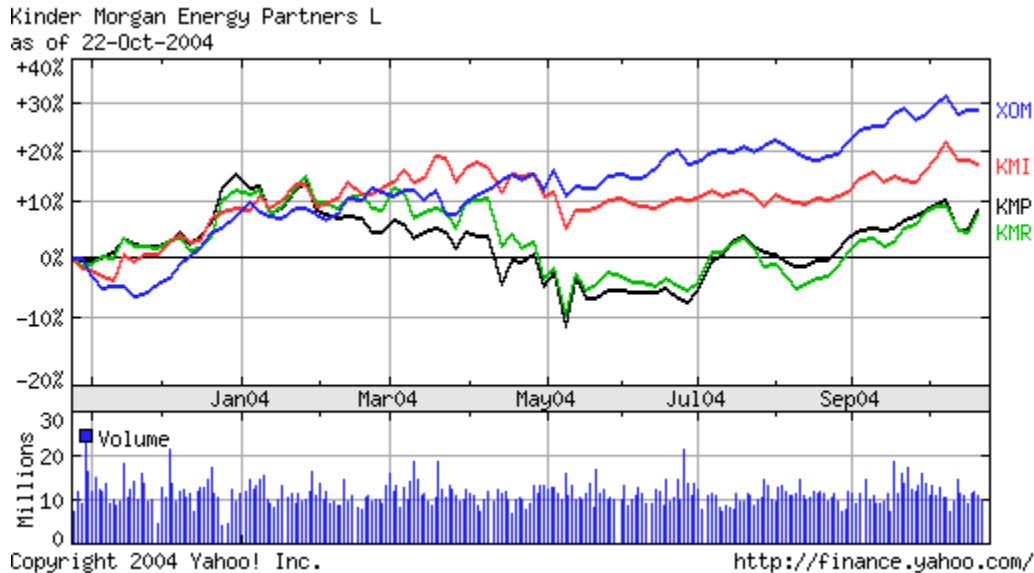
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Management attributes its difficulties to the inability to pass on heating oil price increases and to customer attrition. In one of its gambits to convince investors of the stability of its cash flow, management used weather insurance. Unfortunately, Star could not weather all contingencies. Moreover, being a highly leveraged partnership that used debt to finance distributions, Star had no long underwear. The Star example illustrates a type of risk that may not show up right away, but is catastrophic when it occurs. Investors need to recognize such vulnerability and avoid it, in our opinion.

### **Kinder Morgan Underperforms**

Though Kinder Morgan stock has not collapsed in the past year, it has underperformed the energy industry. We compare the three KMx stocks with the largest, lowest risk energy stock, **ExxonMobil (XOM)** (see chart).



The difference widens when one adjusts for financial risk. For example, XOM has a ratio of debt to present value of 0.08; KMI 0.74 (from table [Rank by McDep Ratio](#)). Equal positions in unlevered present value would have the amount invested in XOM stock 3.5 times the amount invested in KMI stock  $(1-0.08)/(1-0.74)$ . Alternatively, one could say that the unlevered return in XOM was 27% (29% times  $(1-.08)$ ) compared to KMI at only 5% (18% times  $(1-.74)$ ). In separate analyses also dated October 26, we discuss the risks of KMx further.

### **Natural Gas Strengthens**

Natural gas closed some of the gap with crude oil in the past week (see charts [Six-Year and One-Year Natural Gas and Oil Futures](#) and [Six-Year Commodity Price Meter](#)).

There also appears to be a wide gap between oil in the futures market and oil in stocks.

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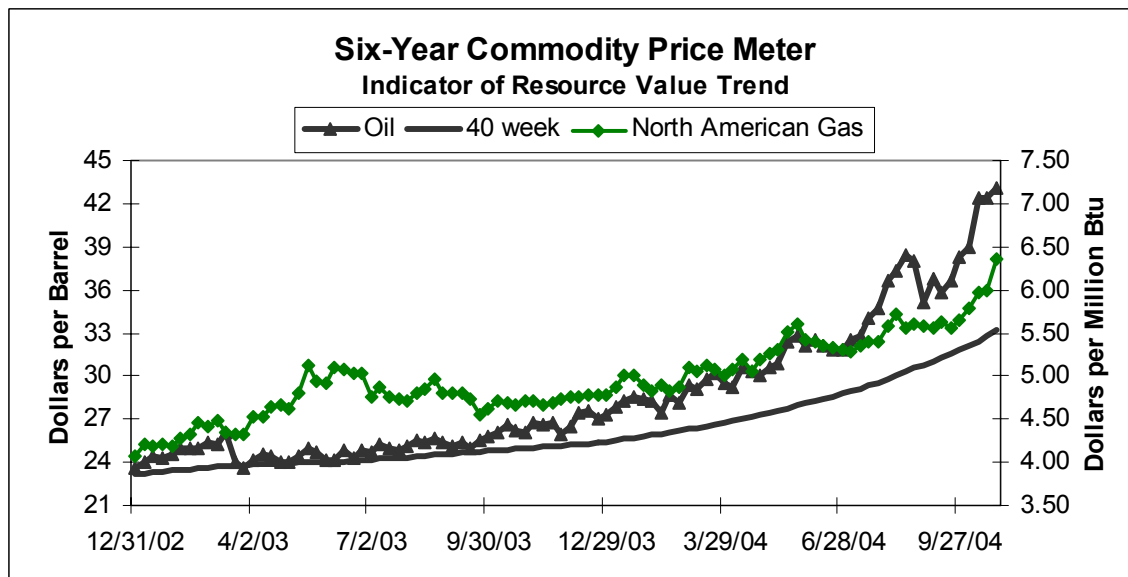
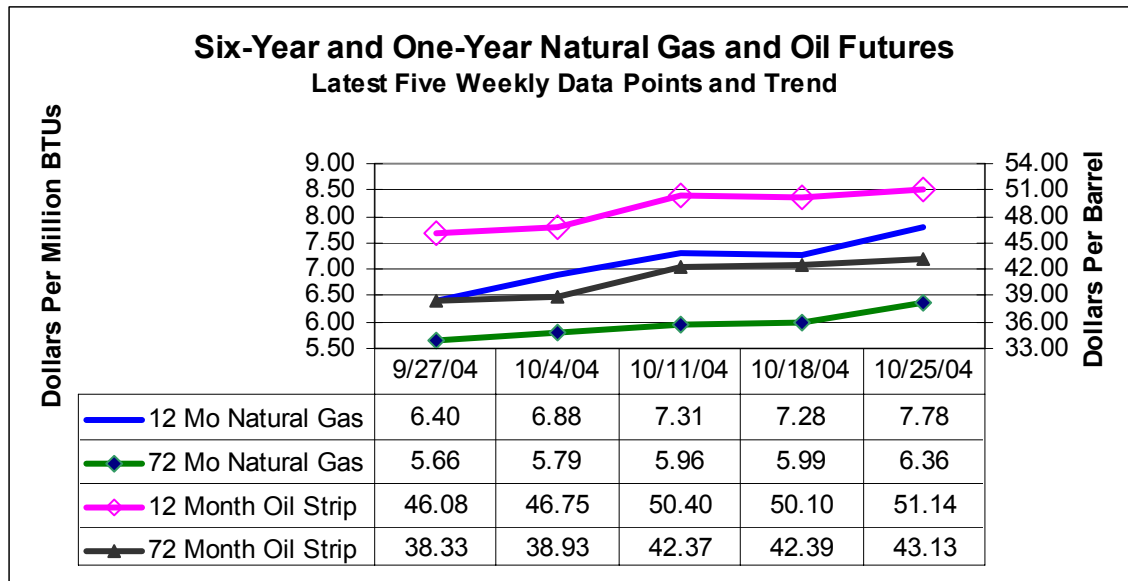
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The assumption of \$35 a barrel constant real price in our estimates of present value seems amply justified. For recommendations and valuation measures, see tables [Rank by McDep Ratio](#) and [Rank by EV/Ebitda](#). The median unlevered cash flow multiple is remarkably low at 4.4 times. For recent single-stock research, see [Index of Stock Ideas](#).

Kurt H. Wulff, CFA



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#### Rated Oil and Gas Producers Rank by McDep Ratio: Market Cap and Debt to Present Value

	Symbol/ Rating	Price (\$/sh) 25-Oct 2004	Shares (mm)	Market Cap (\$mm)	Net Present Value (\$/sh)	Debt/ Present Value	McDep Ratio
<b>Mega Cap</b>							
Exxon Mobil Corporation	XOM B3	48.81	6,547	320,000	43.00	0.08	1.12
BP plc	BP B3	59.48	3,651	217,000	60.00	0.13	0.99
Total S.A.	TOT B3	103.82	1,237	128,500	113.00	0.16	0.93
Shell Transport and Trading Co. plc	SC B3	45.96	1,587	73,000	51.20	0.17	0.92
Royal Dutch Petroleum	RD B1	53.04	2,031	108,000	60.00	0.17	0.90
ChevronTexaco Corporation	CVX B1	53.44	2,130	113,800	62.50	0.14	0.87
<i>Total or Median</i>				960,000		0.15	0.92
<b>Producer/Refiners - Large Cap and Mid Cap</b>							
Kinder Morgan, Inc.	KMI S2	63.00	125	7,860	20.00	0.74	1.56
Imperial Oil Limited (30%)	IMO B3	59.03	107	6,310	52.00	0.11	1.12
Marathon Oil Corporation	MRO B3	40.15	346	13,900	41.00	0.30	0.99
Suncor Energy	SU B3	35.09	460	16,140	38.00	0.13	0.93
Norsk Hydro ASA	NHY B1	74.50	254	18,930	90.00	0.17	0.86
Petro-Canada	PCZ B3	55.80	266	14,850	68.00	0.15	0.85
ConocoPhillips	COP B1	84.92	699	59,400	110.00	0.25	0.83
PetroChina Company Ltd (10%)	PTR B2	53.35	176	9,380	82.00	0.06	0.67
Lukoil Oil Company	LUKOY B2	124.25	209	26,000	208.00	0.05	0.62
<i>Total or Median</i>				173,000		0.15	0.86
<b>Independent Natural Gas and Oil - Large Cap and Mid Cap</b>							
XTO Energy Inc.	XTO B1	35.09	266	9,320	38.00	0.19	0.94
CNOOC Limited (19%)	CEO B2	52.57	78	4,110	59.00	-	0.89
Encana Corporation	ECA B1	49.05	471	23,100	63.00	0.25	0.84
Unocal Corporation	UCL B3	41.73	278	11,600	54.00	0.25	0.83
Occidental Petroleum Corp.	OXY B3	58.46	399	23,300	75.00	0.18	0.82
Anadarko Petroleum Corp.	APC B1	70.00	254	17,800	94.00	0.21	0.80
Burlington Resources	BR B1	42.81	395	16,900	58.00	0.14	0.77
Devon Energy Corporation	DVN B3	76.39	249	19,000	110.00	0.24	0.77
<i>Total or Median</i>				125,000		0.20	0.82
<b>Independent Natural Gas and Oil - Small Cap</b>							
Cimarex Energy Company	XEC B2	35.88	43	1,530	38.00	0.00	0.94
Berry Petroleum Company	BRY B2	38.64	22	870	43.00	0.06	0.91
Energy Partners Ltd.	EPL B3	17.88	38	690	22.00	0.14	0.84
Encore Acquisition Company	EAC B2	34.00	33	1,110	47.00	0.20	0.78
<i>Total or Median</i>				4,200		0.10	0.88
<b>Income</b>							
Kinder Morgan Energy Partners, L.P.	KMP S3	47.35	145	6,870	15.00	0.52	2.04
Kinder Morgan Management, LLC	KMR S3	41.61	54	2,250	15.00	0.52	1.85
San Juan Basin Royalty Trust	SJT H	32.90	47	1,530	27.00	-	1.22
Canadian Oil Sands Trust (US\$)	COSWF B1	50.70	92	4,670	72.00	0.17	0.75
<i>Total or Median</i>				15,300		0.35	1.53

B1 = Buy full unlevered position, B2 = Buy half unlevered position, B3 = Alternative buy

S2 = Short half unlevered position, S3 = Short quarter unlevered position

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses

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#### Rated Oil and Gas Producers

##### Rank by EV/Ebitda: Enterprise Value to Earnings Before Interest, Tax, Deprec.

	Symbol/ Rating		Price (\$/sh) 25-Oct 2004	Adjstd Resrvs/ Prod NTM	PV/ Ebitda NTM	EV/ Ebitda NTM	P/E NTM	Divd or Distrib NTM (%)
<b>Mega Cap</b>								
Exxon Mobil Corporation	XOM	B3	48.81	11.1	5.6	6.3	11	2.2
Total S.A.	TOT	B3	103.82	9.1	6.3	5.8	10	2.8
BP plc	BP	B3	59.48	9.7	5.6	5.6	10	2.9
Shell Transport and Trading Co. plc	SC	B3	45.96	8.2	4.8	4.4	8	4.1
Royal Dutch Petroleum	RD	B1	53.04	8.2	4.8	4.4	8	4.2
ChevronTexaco Corporation	CVX	B1	53.44	11.0	4.8	4.2	7	3.0
	<i>Median</i>			9.4	5.2	5.0	9	2.9
<b>Producer/Refiners - Large Cap and Mid Cap</b>								
Kinder Morgan, Inc.	KMI	S2	63.00		8.3	12.9	16	3.6
Suncor Energy	SU	B3	35.09	18.3	6.5	6.1	13	0.5
Imperial Oil Limited (30%)	IMO	B3	59.03	11.2	5.1	5.7	10	1.2
Marathon Oil Corporation	MRO	B3	40.15	7.4	4.6	4.5	8	2.5
PetroChina Company Ltd (10%)	PTR	B2	53.35	13.5	6.1	4.1	8	4.4
Norsk Hydro ASA	NHY	B1	74.50	9.4	4.7	4.1	9	2.2
ConocoPhillips	COP	B1	84.92	11.2	5.0	4.1	6	2.0
Petro-Canada	PCZ	B3	55.80	7.7	4.5	3.8	7	0.9
Lukoil Oil Company	LUKOY	B2	124.25	12.2	4.5	2.8	5	2.7
	<i>Median</i>			11.2	5.0	4.1	8	2.2
<b>Independent Natural Gas and Oil - Large Cap and Mid Cap</b>								
XTO Energy Inc.	XTO	B1	35.09	11.7	4.9	4.6	9	0.1
CNOOC Limited (19%)	CEO	B2	52.57	10.4	5.4	4.8	9	3.4
Occidental Petroleum Corp.	OXY	B3	58.46	11.2	5.2	4.3	7	1.9
Anadarko Petroleum Corp.	APC	B1	70.00	11.4	5.1	4.1	7	0.8
Encana Corporation	ECA	B1	49.05	6.7	4.7	3.9	7	0.8
Unocal Corporation	UCL	B3	41.73	9.0	4.8	3.9	7	1.9
Burlington Resources	BR	B1	42.81	9.9	5.0	3.8	7	0.8
Devon Energy Corporation	DVN	B3	76.39	6.6	4.2	3.3	5	0.5
	<i>Median</i>			10.1	4.9	4.0	7	0.8
<b>Independent Natural Gas and Oil - Small Cap</b>								
Encore Acquisition Company	EAC	B2	34.00	12.0	5.9	4.6	8	-
Berry Petroleum Company	BRY	B2	38.64	12.8	4.8	4.3	9	1.1
Cimarex Energy Company	XEC	B2	35.88	5.2	3.3	3.1	7	-
Energy Partners Ltd.	EPL	B3	17.88	5.0	3.2	2.7	7	-
	<i>Median</i>			8.6	4.0	3.7	8	-
<b>Income</b>								
Kinder Morgan Energy Partners, L.P.	KMP	S3	47.35	12.0	7.9	16.0	21	6.2
Kinder Morgan Management, LLC	KMR	S3	41.61	12.0	7.9	14.6	18	7.0
San Juan Basin Royalty Trust	SJT	H	32.90	12.5	7.6	9.2	10	9.6
Canadian Oil Sands Trust (USS)	COSWF	B1	50.70	20.0	8.8	6.7	8	3.1
	<i>Median</i>			12.2	7.9	11.9	14	6.6

EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended September 30, 2005; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses

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#### **Index of Stock Ideas Recent Written Analyses**

<u>Date</u>	<u>Symbol</u>	<u>Stock</u>	<u>Theme</u>
26-Oct	KMI	Kinder Morgan Inc.	Fallen Star
26-Oct	KMP	Kinder Morgan Energy Partners, L.P.	Fallen Star
26-Oct	KMR	Kinder Morgan Management, LLC	Fallen Star
18-Oct	NHY	Norsk Hydro ASA	High Cash Flow
11-Oct	COSWF	Canadian Oil Sands Trust	Raise Present Value to US\$72 a Unit
11-Oct	SJT	San Juan Basin Royalty Trust	Raise Present Value to \$27 a Unit
11-Oct	BR	Burlington Resources, Inc.	Natural Gas Sensitivity
6-Oct	COSWF	Canadian Oil Sands Trust	Ten Percent Holder Surfaces
5-Oct	LUKOY	Lukoil Oil Company	SEC Standard Reduces Reserves
30-Sep	LUKOY	Lukoil Oil Company	ConocoPhillips Partner Confirmed
30-Sep	COP	ConocoPhillips	Lukoil Investment Confirmed
28-Sep	RD	Royal Dutch Petroleum	Low Risk, Attractive Reward
28-Sep	SC	Shell Transport & Trading Company, p.l.c.	Low Risk, Attractive Reward
20-Sep	* BP	BP p.l.c.	Betting on Putin
20-Sep	* LUKOY	Lukoil Oil Company	ConocoPhillips Partner
8-Sep	* CEO	CNOOC Ltd ADS	Higher Dividend, Higher Present Value
8-Sep	* PTR	PetroChina Company Limited	Dividend Raised, Present Value Trimmed
8-Sep	* XTO	XTO Energy Inc.	High Performance, High Compensation
7-Sep	* APC	Anadarko Petroleum Corporation	Commodity Alternative
7-Sep	* XEC	Cimarex Energy Company	High Present Value per Barrel
3-Sep	* EAC	Encore Acquisition Company	Rising Recovery and Leadership
2-Sep	* ECA	EnCana Corporation	Encomparable
2-Sep	* KMI	Kinder Morgan Inc.	Momentum Challenge
2-Sep	* KMP	Kinder Morgan Energy Partners, L.P.	Momentum Challenge
2-Sep	* KMR	Kinder Morgan Management, LLC	Momentum Challenge
31-Aug	* COP	ConocoPhillips	Lukoil Investor?
27-Aug	* EPL	Energy Partners, Ltd.	Volume Acceleration
27-Aug	* MRO	Marathon Oil Corporation	Tilting to Refining
26-Aug	* BP	BP p.l.c.	Russia Distinction
26-Aug	* TOT	Total S.A.	Shell Acquirer?
23-Aug	* OXY	Occidental Petroleum Corporation	Oil Rich
23-Aug	* UCL	Unocal Corporation	Asian Natural Gas and Oil
16-Aug	* IMO	Imperial Oil Limited	Choice Piece of ExxonMobil
16-Aug	* PCZ	Petro-Canada	Encana Partner
16-Aug	* SU	Suncor Energy Inc.	A Boone and Charlie Favorite
13-Aug	* BRY	Berry Petroleum Company	New Leader, New Prospects
12-Aug	* DVN	Devon Energy Corporation	Capable Leader, Short Reserve Life
6-Aug	* XOM	Exxon Mobil Corporation	Low Risk with Oil Price Upside
4-Aug	* CVX	ChevronTexaco Corporation	Stock Price Lagging Oil Price
2-Aug	* SJT	San Juan Basin Royalty Trust	Change Buy to Hold on Price
29-Jul	* COSWF	Canadian Oil Sands Trust	Great North American Energy Resource

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