Rating: Sell
S&P 500: 1122

Kinder Morgan Energy Partners, L.P.
High Risk Compensation Model

Symbol	KMP	*Ebitda Next Twelve Months ending 3/31/05 (US$mm)*	530
Rating	Sell	*North American Natural Gas/Ebitda (%)*	0
Price (US$/sh)	40.61	*Natural Gas and Oil Production/Ebitda (%)*	22
Pricing Date	6/4/04	*Adjusted Reserves/Production NTM*	12.0
Shares (mm)	145	*EV/Ebitda*	15.0
Market Capitalization (US$mm)	5,890	*PV/Ebitda*	8.0
Debt (US$mm)	2,080	*Undeveloped Reserves (%)*	50
Enterprise Value (EV) (US$mm)	7,970	*Natural Gas and Oil Ebitda (US$/boe)*	23.78
Present Value (PV) (US$mm)	4,250	*Present Value Proven Reserves(US$/boe)*	12.25
Net Present Value (US$/share)	15	*Present Value Proven Reserves(US$/mcfe)*	2.04
Debt/Present Value	0.49	*Earnings Next Twelve Months (US$/sh)*	1.96
McDep Ratio - EV/PV	1.87	*Price/Earnings Next Twelve Months*	21
Distribution Yield (%/year)	6.8	*Indicated Annual Distribution (US$/sh)*	2.76

Note: Estimated cash flow and earnings at recent quarter rate annualized.
Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

Summary and Recommendation

We continue to recommend sale of the units of **Kinder Morgan Energy Partners (KMP)** on the basis of overvaluation, high financial risk and high business risk. Investors are paying 15 times cash flow for participation in properties that change hands in the industry for half that multiple, or less. A high ratio of debt understates financial risk because the partnership is interconnected with a general partner in an entity whose consolidated ratio of debt is higher. High compensation of 41% of cash distributions to the general partner creates misplaced incentives to sacrifice maintenance and understate the accounting impact. We see some 63% depreciation potential to net present value of $15 a share subject to the main concern that the market can be slow to recognize overvaluation and environmental jeopardy.

Value Business at Eight Times Cash Flow

Our process of estimating company-specific present value begins with an estimate of next twelve months cash flow. Current projections lead to a healthy level of unlevered cash flow, also known as Ebitda, short for earnings before interest, tax, depreciation and amortization (see table). We choose the next twelve months ending March 31, 2005 as the relevant time period.

For the next twelve months we project operations near the first quarter 2004 level. That is sufficient for our valuation calculation. We assess a multiple of 8.0 times to estimate a present value for all the partnership's businesses. That is higher than the 6.0 times we assess for the largest publicly-held energy operations in the world. It is lower than the 9.0 times we have assessed in the past for high-quality, utility-type operations.

Management has emphasized the fixed, predictable fee character that it tries to achieve for the partnership. Such an approach often looks good for awhile, but can be inflexible in adapting to change.

Kinder Morgan Energy Partners, L.P.
Next Twelve Months Financial Results

	Q1	*Q2E*	*Q3E*	*Q4E*	***Year***	*Q1E*	***Next Twelve Months***
	3/31/04	*6/30/04*	*9/30/04*	*12/31/04*	***2004E***	*3/31/05*	***3/31/05***
Revenue ($mm)	1,822	1,695	1,681	1,548	**6,746**	1,822	**6,746**
Expense	1,515	1,388	1,374	1,241	**5,518**	1,515	**5,518**
Ebitda							
Products Pipelines	114	114	114	114	**456**	114	**456**
Natural Gas Pipelines	103	103	103	103	**412**	103	**412**
CO2 Pipelines	78	78	78	78	**312**	78	**312**
Terminals	63	63	63	63	**252**	63	**252**
Overhead	(51)	(51)	(51)	(51)	**(203)**	(51)	**(203)**
Total Ebitda	307	307	307	307	**1,229**	307	**1,229**
Deprec., Deplet., & Amort.	68	68	68	68	**272**	68	**272**
Ebit	239	239	239	239	**957**	239	**957**
Interest	47	47	47	47	**188**	47	**188**
Ebt	192	192	192	192	**769**	192	**769**
General Partner	92	95	95	96	**378**	96	**382**
Net Income ($mm)	100	97	97	97	**391**	96	**387**
Units (mm)	193	196	197	198	**196**	199	**198**
Net Income Per Unit ($/un)	0.52	0.50	0.49	0.49	**1.99**	0.48	**1.96**
Distribution Per L.P. Unit	0.68	0.69	0.69	0.69	**2.75**	0.69	**2.76**
Distribution ($mm)	222	230	231	232	**916**	233	**928**
General Partner	91	95	95	96	**377**	96	**382**
Limited Partner	131	136	136	137	**539**	137	**546**
General Partner Share							
Earnings	48%	49%	50%	50%	**49%**	50%	**50%**
Distribution	41%	41%	41%	41%	**41%**	41%	**41%**

The largest business, product pipelines, is showing its age. Last year an old gasoline line failed in Arizona causing consternation for consumers in several states. More recently an old underwater line failed in California.

The next business, natural gas pipelines, transmits natural gas mainly intrastate Texas. That is a competitive business with ties to controversy. Recall Coastal States Gas which promised long-term natural gas supply at fixed prices that it could not honor. Recall Texas Oil and Gas which was successfully sold to U.S. Steel that soon could not find the value that it thought it acquired. Recall Houston Natural Gas, a less controversial operation that became a vehicle to launch Enron.

The partnership's third business, labeled carbon dioxide pipelines, is essentially an oil producing business with promising prospects in a higher oil price environment. The partnership has succeeded to ownership of half the Yates oil field, once the jewel of Marathon Oil. Remaining oil-in-place attributable to the partnership is more than a billion barrels. While the partnership does not report reserves, we suggest that only about 50 million of that might be classified as proven recoverable.

Please see disclosures on the final page.

Financial Leverage Understated

At a ratio of debt to present value of 0.49, the partnership has near the maximum debt we would like to see in an energy stock. That is the level just below the 0.50 ratio that has often pointed to distress. Investors who like more leverage might be better advised to add it at the portfolio level by owning more of lower debt companies. That way control of the extra leverage remains in the hands of the investor rather than a management that may not have the same flexibility when faced with distress.

The real story on leverage has to take account of the relationship with the general partner. If one were to assume that the units of the partnership were just another form of ownership in a consolidated entity that included the operations of the partnership and operations of the general partner the ratio of debt to present value would be 0.65. That is an average of the higher ratio we calculate for a proportionally consolidated general partner and the lower ratio for a "self-standing" partnership. In a distress situation creditors are likely to look to both entities to satisfy claims. Further confounding the appearance of separation, the general partner guarantees some of the debt of the partnership.

Compensation Model Increases Business Risk

Though our main point on the stock is overvaluation, it is the full recognition of the general partner's compensation that leads to overvaluation. Because, in an escalating pattern, the general partner currently receives 41% of the distributions from the partnership, we allocate 41% of present value to the general partner. That leads to a market multiple of cash flow to the limited partner's interest of 15.0 times compared to our present value multiple of 8.0. If we assumed that the general partner was entitled to a more normal, low single digit share, the market cash flow multiple would be nearly 11.0 times.

One source of business risk is that the regulatory authorities eventually require the general partner's compensation to be more fully reflected in the accounting statements. For example, when the partnership recently issued more units the proceeds were recorded as limited partner equity. Alternatively we would argue that as long as the general partner receives 41% of the distributions, limited partner equity should be reduced by 41%. Among the regulators, the Securities and Exchange Commission has been under staffed until recently. At the same time the company is well-connected politically.

Another source of business risk is environmental and legal in connection with safer pipeline operation. Accidents will happen and we can be sympathetic. It is harder to accept when the facilities are operated by a general partner whose high compensation encourages undermaintenance and potential threat to safety and the environment. For example, the partnership's pipelines are as old as single hull tankers. Perhaps the most sensitive should be upgraded to "double hull" standards.

Finally, the partnership's high valuation appears to depend on continued access to the capital markets. Because the distribution encompasses practically all of the cash flow any new investment or debt repayment would have to be financed. The conditions appear delicately balanced for now, but an unexpected upset would likely have a magnified impact.

Kurt H. Wulff, CFA

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