Rating: Sell
S&P 500: 1106

Kinder Morgan Energy Partners, L.P.
Momentum Challenge

Symbol	KMP	*Ebitda Next Twelve Months ending 6/30/05 (US$mm)*	540
Rating	Sell	*North American Natural Gas/Ebitda (%)*	0
Price (US$/sh)	44.91	*Natural Gas and Oil Production/Ebitda (%)*	21
Pricing Date	9/1/04	*Adjusted Reserves/Production NTM*	12.0
Shares (mm)	145	*EV/Ebitda*	15.9
Market Capitalization (US$mm)	6,510	*PV/Ebitda*	7.9
Debt (US$mm)	2,120	*Undeveloped Reserves (%)*	50
Enterprise Value (EV) (US$mm)	8,640	*Natural Gas and Oil Ebitda (US$/boe)*	24.07
Present Value (PV) (US$mm)	4,300	*Present Value Proven Reserves(US$/boe)*	12.10
Net Present Value (US$/share)	15	*Present Value Proven Reserves(US$/mcfe)*	2.02
Debt/Present Value	0.49	*Earnings Next Twelve Months (US$/sh)*	2.04
McDep Ratio - EV/PV	2.01	*Price/Earnings Next Twelve Months*	22
Distribution Yield (%/year)	6.3	*Indicated Annual Distribution (US$/sh)*	2.84

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 high valuation, high financial risk and high business risk. The partnership continues to report incremental progress in natural gas pipelines, oil products and enhanced oil recovery and has increased its quarterly distribution. In particular, we believe the partnership has a valuable asset in its 50% ownership of the Yates oil field in West Texas. Yet as the stock appears to be trading without momentum on its 200 day average, we reaffirm our concerns.

Investors are Paying about Twice the Value of the Businesses

Projected cash flow of about $1270 million for the Next Twelve Months ended June 30, 2005 remains about the same as when we projected it for the period ended three months earlier. Actual results will reflect industry conditions, investment decisions and operating actions that might be anticipated in more detail, but the illustration is sufficient for valuation perspective (see table Next Twelve Months Financial Results).

At least 198 million units are likely to be outstanding for the period and would be entitled to 59% of the distribution at the new rate. The units include about 145 million for the limited partners of **Kinder Morgan Energy Partners (KMP)** and 53 million i-shares of **Kinder Morgan Management (KMR)**. The current unit prices imply an equity market value of $8.6 billion for rights to 59% of the cash distributed, or $14.7 billion for the rights to all the distribution. Add $5.0 billion of debt and the Enterprise Value becomes $19.7 billion. The numbers are larger than those in the masthead above because they combine the amounts attributed to KMP limited partners, KMR shareholders and the residual for the general partner.

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

	Q1 3/31/04	*Q2 6/30/04*	*Q3E 9/30/04*	*Q4E 12/31/04*	***Year 2004E***	*Q1E 3/31/05*	*Q2E 6/30/05*	***Next Twelve Months 6/30/05***
Ebitda								
Products Pipelines	114	119	119	119	**471**	119	119	**476**
Natural Gas Pipelines	103	95	95	103	**396**	103	95	**396**
CO2 Pipelines	78	76	76	76	**306**	76	76	**304**
Terminals	63	66	66	66	**261**	66	66	**264**
Overhead	(51)	(43)	(43)	(46)	**(183)**	(44)	(36)	**(169)**
Total Ebitda	307	313	313	318	**1,251**	320	320	**1,271**
Deprec., Deplet., & Amort.	68	70	70	70	**278**	70	70	**280**
Ebit	239	243	243	248	**973**	250	250	**991**
Interest	47	47	47	47	**188**	47	47	**188**
Ebt	192	196	196	201	**785**	203	203	**803**
General Partner	92	96	99	99	**386**	100	100	**399**
Net Income ($mm)	100	100	97	102	**399**	103	103	**404**
Units (mm)	193	196	197	198	**196**	199	200	**198**
Net Income Per Unit ($/un)	0.52	0.51	0.49	0.51	**2.04**	0.52	0.51	**2.04**
Distribution Per L.P. Unit	0.68	0.69	0.71	0.71	**2.79**	0.71	0.71	**2.84**
Distribution ($mm)	222	230	239	240	**930**	241	242	**962**
General Partner	91	95	99	99	**384**	100	100	**399**
Limited Partner	131	135	140	140	**546**	141	142	**563**
General Partner Share								
Earnings	48%	49%	50%	49%	**49%**	49%	49%	**50%**
Distribution	41%	41%	41%	41%	**41%**	41%	41%	**41%**

Now we can calculate a ratio of Enterprise Value to unlevered cash flow, EV/Ebitda, of 15.5 times. In contrast, we assess the value of the businesses at 7.9 times. On August 31, the partnership announced a $100 million pipeline acquisition it asserted would produce $18 million annually in distributable cash flow. The purchase price translates to 5.6 times cash flow though we may never know all the details. If incremental transactions are priced that low, it tends to confirm that the partnership's mix of existing operations are not likely worth much more on average.

How can investors justify paying almost twice business value? Most likely the investors in the partnership put an unusually high value on the perception of steady income. Investors are encouraged to believe that the KMP distribution now at 6.5% a year can also grow perhaps 8% per year or more to deliver a total return of 15% a year. That indeed would be an attractive return though it would take many years of growth without selling units to achieve it in reality.

The inconsistency in those expectations is that the underlying properties are unlikely to earn more than 15% a year. After distributing 41% of the return to the general partner for no capital outlay, there is not enough left for investors to justify the risks they are taking, in our opinion.

If the KMP properties earn 15% a year, other properties in the energy industry would probably earn the same. Investors can buy the best, lowest risk companies in the industry for cash flow multiples at or below the value of the underlying businesses. Where those companies pay lower current income, an enterprising fund manager could structure a similar income profile as that of KMP, charge a respectable fee and still offer better net value.

Financial Risk Appears Understated

The general partner of KMP, **Kinder Morgan, Inc. (KMI)**, not only receives 41% of the distributed cash, but also owns units or i-shares that increase its ownership to the point where the combined interest is about 51% of the partnership. Under normal circumstances a 51% owned entity would be consolidated on the balance sheet of the owner. Yet KMI does not count most of the general partner share of distribution as ownership and thus claims that it owns less than 20% of the partnership. Therefore it is not required to show the debt of the partnership on KMI's balance sheet. As a result, KMI can say it has only about 50% debt and KMP has only about 50% debt when the reality is that the combined entities have about 65% debt. Some investors may applaud KMI for being so clever. Others may consider it a red flag when a company hides debt in a partnership. In the end the risks of the general partner and the partnership are linked.

Compensation Creates Misplaced Incentives

The third distinctive feature and risk factor is the 41% general partner compensation. While individuals are free to pay any compensation to managers that they wish, institutions have a fiduciary responsibility. In fact few institutions seem to own KMP. Yet KMR is designed for institutions. We see a problem for most institutions to justify owning that stock because each new dollar invested essentially puts $.41 into the pocket of the general partner who makes essentially no capital outlay. Private equity and hedge fund compensation at 20% of gains appears institutionally acceptable. 41% compensation to a general partner regardless of gains appears to be pushing the envelope. It may not be a problem as long as it works, but it could be indefensible if it doesn't.

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