

Rating: Sell  
 S&P 500: 1189

## Kinder Morgan Energy Partners Wheel and Deal

Symbol	KMI	KMP	KMR	KMx	Terasen		KMx/TER
Rating	Sell	Sell	Sell				
Price (US\$/sh)	88.99	52.27	47.87		29.59		
Pricing Date	10/19/05	10/19/05	10/19/05				
Publicly Held Shares (mm)	123	139	43		106		
Market Capitalization (US\$m)	10,900	7,290	2,080	20,300	3100	-2100	21,300
Debt (US\$m)	7,700	2,580	810	11,100	2400	1100	14,600
Enterprise Value (EV) (US\$m)	18,600	9,870	2,890	31,400	5500		35900
Present Value (PV) (US\$m)	10,200	4,680	1,460	16,300	5500		21,800
Net Present Value (US\$/share)	20	15	15				
Debt/Present Value	0.76	0.55	0.55	0.68	0.44		0.67
McDep Ratio - EV/PV	1.84	2.11	1.98	1.92	1.00		1.65
Ebitda Next Twelve Months ending 9/30/06 (US\$m)	1,350	600	184	2,130	490		2,620
North American Natural Gas/Ebitda (%)	0	0	0				
Natural Gas and Oil Production/Ebitda (%)	10	17	17				
Adjusted Reserves/Production NTM	6.4	6.4	6.4				
EV/Ebitda	13.8	16.7	15.6	14.7	11.2		13.7
PV/Ebitda	7.5	7.9	7.9	7.7	11.2		8.3
Undeveloped Reserves (%)	42	42	42				
Natural Gas and Oil Ebitda (US\$/boe)	20.37	20.37	20.37				
Present Value Proven Reserves(US\$/boe)	17.48	17.48	17.49				
Present Value Proven Reserves(US\$/mcf)	2.91	2.91	2.91				
Earnings Next Twelve Months (US\$/sh)	4.82	2.21	2.21		1.36		
Price/Earnings Next Twelve Months	18	24	22	20	22		
Indicated Annual Distribution (US\$/sh)	3.00	3.16	3.16		0.74		
Distribution Yield (%/yr)	3.4	6.0	6.6	4.7	2.5		
Ebitda by Function							
Natural Gas Pipelines	764	169	52	984			
Oil Products Pipelines	221	162	50	433			
CO2 Pipelines	218	160	49	427			
Terminals	148	109	33	291			

Reported results may vary widely from estimates.

Estimated present value per share revised only infrequently.

### Summary and Recommendation

Sell-recommended **Kinder Morgan Inc. (KMI)**, **Kinder Morgan Energy Partners (KMP)**, and **Kinder Morgan Management LLC (KMR)** have embarked on a flurry of initiatives to be the transporter of new oil from the sands of Alberta, new natural gas from the Rocky Mountains and gasified liquid from new import terminals. Amid the frantic activity, KM overstates its financial situation as we see it. Ignored by adulatory analysts and journalists, the company's tactics are similar to those of early issuers of convertible securities and stock options before the accounting rules were more properly applied. A regulatory proceeding underway in British Columbia has the potential to bring more reality to the valuation of KM securities. Taking account of latest rosy results we continue to estimate potential stock price depreciation of 50% or more. To mitigate the risk that depreciation is postponed we recommend that investors after selling KM own an amount of a buy-recommended stock about equal in present value.

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### **Rocky Mountain Pipeline Would Tap Municipal Finance**

Just as KM recognizes a developing strategic opportunity in Canada, it sees a valid need for new pipeline capacity to move natural gas from growing supplies in the Rocky Mountains to eastern markets. KM would be a 70% partner in a \$3 billion project. Applying the creativity it applies to accounting, KM has the idea that the state of Wyoming could issue tax-exempt financing to help the pipeline. The state would be moving some of its own royalty gas through the line.

### **Louisiana Pipeline Would Handle Gasified Liquid Imports**

If there is new pipeline business, KM is interested. Why not a line to handle growing volumes from regasifying of imported liquefied natural gas? That is the avowed purpose of another half billion dollar proposed project.

### **Disguised Equity in General Partner Compensation**

Some of the most extreme stock options schemes contributed to the stock market collapse in 2002. Today, the abuse of stock options seems considerably diminished in the wake of an adverse public and regulatory reaction.

Twenty eight years earlier a popular technique of investor abuse was the issuance of convertible securities. Sure they might be disclosed in footnotes somewhere, but often no mention was made in reported earnings. Today we take it for granted that reported earnings are “fully diluted” to take account of surprise issuance of new shares.

We see a parallel situation with KM’s deceptive reporting of its general partner “incentive compensation” interest. That interest is just as much of an equity interest as are stock options or convertible securities. KM gets away with it because there are not many imitators as advanced as KM in hiding debt and overstating earnings. Presumably the day will come when KM has to come clean. Hopefully it will be sooner rather than later.

### **Overstated Earnings**

As general partner, KMI takes 42% of the cash distributions of KMP, the limited partnership, plus an additional 10% for the units it owns in KMP. The GP is entitled to its 42% share of all future distributions at the current rate. That dilution is not reported as the effective reduction of limited partner equity. Instead limited partner unitholders regularly see an overstatement of the value of their ownership.

The general partner further overstates earnings when it transfers assets to the partnership. Before the transfer, the general partner would report depreciation as a reduction of earnings. After the transfer, the limited partnership distributes most of the depreciation in cash. The general partner reports cash received as earnings. Unless curtailed, KM could keep the game going a long time as there is a backlog of assets owned by the general partner that may be transferred.

### **Understated Debt**

A debt ratio of 0.50 is a normal maximum in the energy industry. The combined KMx entities have a debt ratio of 0.68. Yet investors don’t see that as both the general partner, KMI, and the

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limited partnership, KMP, report leverage near the normal maximum. The explanation is that KMI reports none of the KMP debt on KMI's balance sheet despite the fact that KMI has effective ownership of the partnership of more than 50%. While KMI hides debt in the KMP partnership, management represents its capital structure as "conservative".

A glowing tribute to KM on Bloomberg on October 19 demurred that KM's debt was near the lowest investment grade and on negative credit watch. In our opinion, the credit raters, paid by the companies they rate, have a conflict that unavoidably makes them party to the KM debt ruse. We think the raters should not allow KM to hide debt to gain a higher rating than would otherwise be the case.

### **British Columbia Utilities Commission Weighing KM-Terasen Deal**

KM offers \$4.5 billion of cash and securities to buy Canada's Terasen (see *McDep Stock Idea*, Kinder Morgan, Canada May Block KM-Terasen Deal). There is no public indication yet on whether the BCUC will approve the transaction to change the ownership of the public utility that distributes natural gas in British Columbia. Apparently more than 5000 letters have been sent opposing the transaction and final submissions were received last week from interveners who also oppose by about 9 to 2. There is a reasonable case to be made that the commissioners should allow more time for the issues to be discussed in public hearings. That would give stockholders of Terasen plenty of time to sell at the inflated price tied to the artificial price of KM securities.

### **Pipeline Safety Questioned**

Some courageous regulators at the U.S. Department of Transportation have challenged the safety record of politically well-connected Kinder Morgan. The Department has ordered the company to address an increasing series of incidents on its oil products pipeline apparently including failures in Arizona and California.

Capital expenditures apparently have increased to meet higher operating standards. The general partner's unwarranted compensation creates too much incentive, in our view, to skimp on maintenance and distribute excessive amounts of cash. Earnings and cash flow may be overstated as they exclude payments made this year to settle lawsuits.

### **Cash Flow Looks Good, but Valuation High**

Recently reported cash flow and earnings look better than projected previously. As a result we boost our projections for the Next Twelve Months offset somewhat by more units and debt (see tables [Next Twelve Months Financial Results](#)). Some of the improved industry conditions may be benefiting KM and some of the gains are from acquisitions that we include in our projections on a lagged basis. Investors can participate in industry conditions in stocks with lower valuation. Acquisitions depend on high stock price boosted by apparently false accounting. Some of the extra earnings in KMI come from the mere transfer of an asset from the General Partner to the Limited Partner. When that happens depreciation becomes earnings for the GP and debt disappears from the GP balance sheet magically.

Valuation remains extraordinary. The market cash flow multiple is about 16 times at the partnership. Producer income stocks are a quarter to a half that level (see table Rank by EV/Ebitda).

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**Kinder Morgan, Inc.**  
**Next Twelve Months Financial Results**

	<i>Q4</i>	<i>Year</i>	<i>Q1</i>	<i>Q2</i>	<i>Q3</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Next Twelve Months</i>
	<i>12/31/04</i>	<i>2004</i>	<i>3/31/05</i>	<i>6/30/05</i>	<i>9/30/05</i>	<i>12/31/05</i>	<i>2005E</i>	<i>3/31/06</i>	<i>6/30/06</i>	<i>9/30/06</i>	<i>9/30/06</i>
<b>Ebitda</b>											
Natural Gas Pipelines	201	<b>529</b>	139	97	97	201	<b>534</b>	139	97	97	<b>534</b>
Kinder Morgan Energy Partners	184	<b>674</b>	189	193	204	204	<b>789</b>	204	204	204	<b>815</b>
Total Ebitda	385	<b>1,203</b>	328	290	301	405	<b>1,323</b>	343	301	301	<b>1,349</b>
Deprec., Deplet., & Amort.	30	<b>119</b>	29	30	30	30	<b>119</b>	30	30	30	<b>120</b>
Kinder Morgan Energy Partners	31	<b>115</b>	35	36	35	34	<b>140</b>	34	34	34	<b>137</b>
<b>Ebit</b>	324	<b>969</b>	264	224	236	340	<b>1,064</b>	279	237	237	<b>1,093</b>
Interest	39	<b>154</b>	41	44	45	45	<b>175</b>	45	45	45	<b>180</b>
<b>Ebt</b>	285	<b>815</b>	223	180	191	295	<b>889</b>	234	192	192	<b>913</b>
Income Tax	100	<b>285</b>	78	63	67	103	<b>311</b>	82	67	67	<b>319</b>
<b>Net Income (\$mm)</b>	185	<b>530</b>	145	117	124	192	<b>578</b>	152	124	125	<b>593</b>
<b>Shares (millions)</b>	125	<b>125</b>	124	123	123	123	<b>123</b>	123	123	123	<b>123</b>
Per Share (\$)	1.48	<b>4.24</b>	1.17	0.95	1.01	1.56	<b>4.69</b>	1.24	1.01	1.01	<b>4.82</b>
Tax Rate	35%	<b>35%</b>	35%	35%	35%	35%	<b>35%</b>	35%	35%	35%	<b>35%</b>

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

	<i>Q4</i>	<i>Year</i>	<i>Q1</i>	<i>Q2</i>	<i>Q3</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Next Twelve Months</i>
	<i>12/31/04</i>	<i>2004</i>	<i>3/31/05</i>	<i>6/30/05</i>	<i>9/30/05</i>	<i>12/31/05</i>	<i>2005E</i>	<i>3/31/06</i>	<i>6/30/06</i>	<i>9/30/06</i>	<i>9/30/06</i>
<b>Oil Volume</b>											
Oil (mmb)	4.0		4.0	4.0	3.9	3.9	<b>16</b>	3.8	3.8	3.9	<b>15</b>
Oil (mbd)	43		45	44	42	42	<b>43</b>	42	42	42	<b>42</b>
<b>Oil Price (\$/bbl)</b>											
WTI Cushing	48.31		49.65	53.05	62.52	63.90	<b>57.28</b>	63.41	63.49	63.36	<b>63.54</b>
Partnership	28.12		29.73	28.80	28.98	29.14	<b>29.17</b>	29.09	29.10	29.08	<b>29.10</b>
<b>Oil Revenue (\$mm)</b>	112		120	114	112	112	<b>458</b>	110	111	112	<b>445</b>
<b>Ebitda</b>											
Products Pipelines	122	<b>475</b>	126	123	127	127	<b>503</b>	127	127	127	<b>508</b>
Natural Gas Pipelines	107	<b>410</b>	124	115	122	122	<b>483</b>	122	122	122	<b>488</b>
CO2 Pipelines	114	<b>354</b>	123	115	120	120	<b>478</b>	120	120	120	<b>481</b>
Terminals	67	<b>263</b>	74	78	82	82	<b>316</b>	82	82	82	<b>328</b>
Overhead	(51)	<b>(184)</b>	(79)	(54)	(53)	(53)	<b>(240)</b>	(53)	(53)	(53)	<b>(213)</b>
Total Ebitda	359	<b>1,318</b>	368	377	398	398	<b>1,541</b>	398	398	398	<b>1,592</b>
Deprec., Deplet., & Amort.	79	<b>291</b>	85	88	85	85	<b>343</b>	85	85	85	<b>340</b>
<b>Ebit</b>	280	<b>1,027</b>	283	289	313	313	<b>1,198</b>	313	313	313	<b>1,252</b>
Interest	54	<b>196</b>	59	67	68	68	<b>262</b>	68	68	68	<b>272</b>
<b>Ebt</b>	226	<b>831</b>	224	222	245	245	<b>936</b>	245	245	245	<b>980</b>
General Partner	107	<b>395</b>	112	117	123	125	<b>477</b>	125	126	126	<b>503</b>
<b>Net Income (\$mm)</b>	119	<b>436</b>	112	105	122	120	<b>459</b>	120	119	118	<b>477</b>
<b>Units (mm)</b>	203	<b>197</b>	208	210	214	214	<b>211</b>	215	216	217	<b>216</b>
Net Income Per Unit (\$/un)	0.59	<b>2.21</b>	0.54	0.50	0.57	0.56	<b>2.17</b>	0.56	0.55	0.54	<b>2.21</b>
Distribution Per L.P. Unit	0.73	<b>2.81</b>	0.74	0.76	0.78	0.79	<b>3.07</b>	0.79	0.79	0.79	<b>3.16</b>
<b>Distribution (\$mm)</b>	254	<b>944</b>	265	275	289	294	<b>1,123</b>	296	297	298	<b>1,185</b>
General Partner	106	<b>390</b>	111	116	122	125	<b>474</b>	125	126	126	<b>503</b>
Limited Partner	148	<b>554</b>	154	159	167	169	<b>649</b>	170	171	172	<b>682</b>
<b>General Partner Share</b>											
Earnings	47%	<b>48%</b>	50%	53%	50%	51%	<b>51%</b>	51%	51%	52%	<b>51%</b>
Distribution	42%	<b>41%</b>	42%	42%	42%	42%	<b>42%</b>	42%	42%	42%	<b>42%</b>

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**Oil and Gas Producers**

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

				<i>Price</i> <i>(\$/sh)</i>	<i>Adjstd</i> <i>Resrvs/</i>	<i>PV/</i>	<i>EV/</i>	<i>Divd or</i>	
	<i>Symbol/</i>		<i>19-Oct</i>	<i>Prod</i>	<i>Ebitda</i>	<i>Ebitda</i>	<i>P/E</i>	<i>Distrib</i>	
	<i>Rating</i>		<i>2005</i>	<i>NTM</i>	<i>NTM</i>	<i>NTM</i>	<i>NTM</i>	<i>NTM</i>	<i>(%)</i>
<b>Income</b>									
Kinder Morgan Energy Partners, L.P.	KMP	S3	52.27		7.9	16.7	24	6.0	
Kinder Morgan Management, LLC	KMR	S3	47.87		7.9	15.6	22	6.6	
San Juan Basin Royalty Trust	SJT		42.98	12.0	7.7	8.2	9	11.3	
Canadian Oil Sands Trust (US\$)	COSWF	B	93.15	20.0	10.4	7.5	8	1.8	
Pengrowth Energy Trust	PGH		22.32	7.6	5.1	5.6	8	10.5	
Enerplus Resources Fund	ERF		43.77	9.8	5.1	5.3	7	9.8	
Penn West Energy Trust	PWTFF	B	27.22	8.0	4.1	4.0	6	11.6	
	<i>Median</i>			<i>9.8</i>	<i>7.7</i>	<i>7.5</i>	<i>8</i>	<i>9.8</i>	

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