

Rating: Sell  
 S&P 500: 1229

## **Kinder Morgan Management LLC Canada May Block KM-Terasen Deal**

<i>Symbol</i>	KMI	KMP	KMR	KMx	Terasen	KMx/TER	
<i>Rating</i>	Sell	Sell	Sell				
<i>Price (US\$/sh)</i>	92.12	52.29	48.8		29.68		
<i>Pricing Date</i>	8/8/05	08/08/05	08/08/05				
<i>Publicly Held Shares (mm)</i>	123	136	41		106		
<i>Market Capitalization (US\$mm)</i>	11,300	7,140	2,020	20,500	3100	-2100	21,500
<i>Debt (US\$mm)</i>	7,700	2,530	770	11,000	2400	1100	14,500
<i>Enterprise Value (EV) (US\$mm)</i>	19,000	9,670	2,790	31,500	5500		36000
<i>Present Value (PV) (US\$mm)</i>	10,100	4,590	1,390	16,100	5500		21,600
<i>Net Present Value (US\$/share)</i>	20	15	15				
<i>Debt/Present Value</i>	0.76	0.55	0.55	0.68	0.44		0.67
<i>McDep Ratio - EV/PV</i>	1.88	2.11	2.01	1.96	1.00		1.67
<i>Ebitda Next Twelve Months ending 6/30/06 (US\$mm)</i>	1,240	560	171	1,970	490		2,460
<i>North American Natural Gas/Ebitda (%)</i>	0	0	0				
<i>Natural Gas and Oil Production/Ebitda (%)</i>	11	20	20				
<i>Adjusted Reserves/Production NTM</i>	6.2	6.2	6.2				
<i>EV/Ebitda</i>	15.3	17.4	16.6	16.0	11.2		14.6
<i>PV/Ebitda</i>	8.2	8.3	8.3	8.2	11.2		8.8
<i>Undeveloped Reserves (%)</i>	42	42	42				
<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	21.24	21.24	21.24				
<i>Present Value Proven Reserves(US\$/boe)</i>	19.58	19.58	19.59				
<i>Present Value Proven Reserves(US\$/mcf)</i>	3.26	3.26	3.27				
<i>Earnings Next Twelve Months (US\$/sh)</i>	4.21	1.84	1.84		1.36		
<i>Price/Earnings Next Twelve Months</i>	22	28	26	24	22		
<i>Indicated Annual Distribution (US\$/sh)</i>	3.00	3.12	3.12		0.74		
<i>Distribution Yield (%/yr)</i>	3.3	6.0	6.4	4.5	2.5		

### **Summary and Recommendation**

Shares of sell-recommended **Kinder Morgan Inc. (KMI)**, **Kinder Morgan Energy Partners (KMP)**, and **Kinder Morgan Management LLC (KMR)** advanced recently on the news that KMI would acquire the British Columbia utility, Terasen, Inc. We suggest that the regulatory authorities in Canada may block the deal on the grounds of fairness because the U.S. government subsidizes Kinder Morgan by allowing it to overstate earnings. The government also sponsors an oligopoly of U.S. bond raters, paid by the companies they rate, who allow KM to understate debt. Canadians would be exchanging ownership and control of strategic assets for inflated stock and a high-risk financial structure, in our opinion.

### **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. Current GP compensation is treated as an expense that reduces limited partner earnings. Yet 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.

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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, even that associated with depreciation. There are a lot of assets owned by the general partner that could be transferred to keep the game going. Canadian assets eventually may be “sent down to KMP” as an analyst puts it on the call explaining the deal.

### **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 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”.

We detected skepticism on the part of some analysts on the conference call discussing the proposed deal. That analysts appeared concerned whether the debt-rating agencies would continue to embrace management's rationalization that KMP debt was “downstream” from KMI and thus should not be counted. The suggestion is that KM may fake its leverage when it describes its offer to Canadian sellers.

### **Extraordinary Valuation**

Overstating earnings and understating debt might not be so significant if Kinder Morgan was an undervalued stock. Instead by an objective valuation measure, Enterprise Value to Ebitda, the separate entities or the combined entities are more highly valued by a wide margin than any of the leading energy companies in the industry (see table Rank by EV/Ebitda). KM has nearly twice the valuation of buy-recommendations **Imperial Oil (IMO)** and **Suncor (SU)** and three times the valuation of **Petro-Canada (PCZ)**.

Confusing accounting causes analysts and data sources to misinterpret valuation of the stocks. A respected source like Bloomberg, for example, reports an EV/Ebitda multiple of 9 times for KMP compared to our calculation of almost 18 times. Bloomberg reports a debt ratio of .44 for KMI compared to our estimate of 0.76. Disingenuous accounting appears to have contributed to excess valuation.

It looks like KM is offering about 11 times Ebitda for Terasen. Who can blame the Terasen owners for being willing to sell their stock for a higher multiple than Imperial Oil enjoys? KM can pay the high multiple because its own multiple is an inflated 16.4 times and would still be 15.4 times after the deal, if approved.

### **No Compensation with Misrepresentation!**

At the root of KM's complicated accounting is the exploding general partner compensation scheme. Created by Enron in the early 1990s, the scheme has spread throughout the pipeline and coal industry. None of the other companies using the method have reached the level achieved by KM to our knowledge. A few prominent players have capped general partner compensation at

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25% to limit perception of abuse. KMI, the general partner, takes 50% of incremental distributions from KMP. KMI's average take is 42% and climbing.

Of course, compensation should be a matter of free choice. A few investors may feel that 50% compensation is deserved. The level of compensation is more significant as it magnifies the overstatement of earnings and understatement of debt. As the colonists chanted "No Taxation without Representation" the citizens of British Columbia might exhort "No Compensation with Misrepresentation".

Yet, in the broader context of the whole stock market, the scope of the KM ruse has not attracted much attention. Whether the British Columbia Utilities Commission is alert remains to be seen. Deals often take months to become final.

Kurt H. Wulff, CFA

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

	Symbol/ Rating		Price (\$/sh) 10-Aug 2005	Adjstd Resrvs/ Prod NTM	PV/ Ebitda NTM	EV/ Ebitda NTM	P/E NTM	Divd or Distrib NTM (%)
<b>Producer/Refiners - Large Cap and Mid Cap</b>								
Kinder Morgan, Inc.	KMI	S2	93.85		8.2	15.5	22	3.2
Suncor Energy	SU	B	57.78	20.7	10.1	8.7	19	0.3
Imperial Oil Limited (30%)	IMO	B	94.93	10.5	6.7	7.4	13	0.8
PetroChina Company Ltd (10%)	PTR	B	92.25	13.7	6.8	5.3	10	3.4
Petro-Canada	PCZ	B	79.42	7.2	5.3	5.0	9	0.8
Marathon Oil Corporation	MRO	B	62.82	7.1	4.8	4.7	7	1.8
ConocoPhillips	COP	B	65.64	11.2	5.9	4.2	6	1.9
Norsk Hydro ASA	NHY	B	102.54	8.2	4.9	4.0	8	3.0
Lukoil Oil Company	LUKOY	B	44.65	19.8	5.1	3.5	6	2.2
	<i>Median</i>			<i>10.9</i>	<i>5.9</i>	<i>5.0</i>	<i>9</i>	<i>1.9</i>
<b>Income</b>								
Kinder Morgan Energy Partners, L.P.	KMP	S3	51.25		8.3	17.1	28	6.1
Kinder Morgan Management, LLC	KMR	S3	47.74		8.3	16.3	26	6.5
San Juan Basin Royalty Trust	SJT		49.25	12.0	9.7	11.9	13	7.7
Canadian Oil Sands Trust (US\$)	COSWF	B	92.25	20.0	10.2	7.3	8	1.8
Pengrowth Energy Trust	PGH		23.80	7.4	5.6	6.5	9	9.5
Enerplus Resources Fund	ERF		40.59	9.4	6.1	6.0	9	8.5
	<i>Median</i>			<i>10.7</i>	<i>8.3</i>	<i>9.6</i>	<i>11</i>	<i>7.1</i>

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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>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</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>6/30/06</i>
<b>Ebitda</b>										
Natural Gas Pipelines	201	<b>529</b>	139	97	98	135	<b>469</b>	139	97	<b>469</b>
Kinder Morgan Energy Partners	185	<b>678</b>	190	194	191	192	<b>768</b>	191	197	<b>771</b>
Total Ebitda	386	<b>1,207</b>	329	291	289	327	<b>1,237</b>	330	294	<b>1,240</b>
Deprec., Deplet., & Amort.	30	<b>119</b>	29	30	30	30	<b>119</b>	30	30	<b>120</b>
Kinder Morgan Energy Partners	32	<b>119</b>	36	37	37	37	<b>147</b>	37	37	<b>146</b>
<b>Ebit</b>	324	<b>969</b>	264	224	222	260	<b>971</b>	264	227	<b>974</b>
Interest	39	<b>154</b>	41	44	44	44	<b>173</b>	44	44	<b>176</b>
<b>Ebt</b>	285	<b>815</b>	223	180	178	216	<b>798</b>	220	183	<b>798</b>
Income Tax	100	<b>285</b>	78	63	62	76	<b>279</b>	77	64	<b>279</b>
<b>Net Income (\$mm)</b>	185	<b>530</b>	145	117	116	141	<b>518</b>	143	119	<b>518</b>
<b>Shares (millions)</b>	125	<b>125</b>	124	123	123	123	<b>123</b>	123	123	<b>123</b>
Per Share (\$)	1.48	<b>4.24</b>	1.17	0.95	0.94	1.14	<b>4.20</b>	1.16	0.97	<b>4.21</b>
Tax Rate	35%	<b>35%</b>	35%	35%	35%	35%	<b>35%</b>	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>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</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>6/30/06</i>
<b>Oil Volume</b>										
Oil (mmb)	4.0		4.0	4.0	4.0	4.0	<b>16</b>	3.9	4.0	<b>16</b>
Oil (mbd)	43		45	44	44	44	<b>44</b>	44	44	<b>44</b>
<b>Oil Price (\$/bbl)</b>										
WTI Cushing	48.31		49.65	53.05	61.58	65.42	<b>57.43</b>	66.21	65.95	<b>64.79</b>
Partnership	28.12		29.73	28.80	29.96	30.42	<b>29.73</b>	30.52	30.49	<b>30.35</b>
<b>Oil Revenue (\$mm)</b>	112		120	114	120	122	<b>476</b>	120	121	<b>482</b>
<b>Ebitda</b>										
Products Pipelines	122	<b>475</b>	126	123	123	123	<b>495</b>	123	123	<b>492</b>
Natural Gas Pipelines	107	<b>410</b>	124	115	105	105	<b>449</b>	105	115	<b>430</b>
CO2 Pipelines	114	<b>354</b>	123	115	119	120	<b>478</b>	119	120	<b>478</b>
Terminals	67	<b>263</b>	74	78	78	78	<b>308</b>	78	78	<b>312</b>
Overhead	(51)	<b>(184)</b>	(79)	(54)	(54)	(54)	<b>(241)</b>	(54)	(54)	<b>(217)</b>
Total Ebitda	359	<b>1,318</b>	368	377	371	372	<b>1,488</b>	371	381	<b>1,495</b>
Deprec., Deplet., & Amort.	79	<b>291</b>	85	88	88	88	<b>349</b>	88	88	<b>352</b>
<b>Ebit</b>	280	<b>1,027</b>	283	289	283	284	<b>1,139</b>	283	293	<b>1,143</b>
Interest	54	<b>196</b>	59	67	67	67	<b>260</b>	67	67	<b>268</b>
<b>Ebt</b>	226	<b>831</b>	224	222	216	217	<b>879</b>	216	226	<b>875</b>
General Partner	107	<b>395</b>	112	117	120	121	<b>470</b>	122	122	<b>485</b>
<b>Net Income (\$mm)</b>	119	<b>436</b>	112	105	95	96	<b>409</b>	94	104	<b>390</b>
<b>Units (mm)</b>	203	<b>197</b>	208	210	210	211	<b>210</b>	212	213	<b>212</b>
Net Income Per Unit (\$/un)	0.59	<b>2.21</b>	0.54	0.50	0.45	0.46	<b>1.95</b>	0.44	0.49	<b>1.84</b>
Distribution Per L.P. Unit	0.73	<b>2.81</b>	0.74	0.76	0.78	0.78	<b>3.06</b>	0.78	0.78	<b>3.12</b>
<b>Distribution (\$mm)</b>	254	<b>944</b>	265	275	285	286	<b>1,110</b>	287	288	<b>1,146</b>
General Partner	106	<b>390</b>	111	116	120	121	<b>468</b>	122	122	<b>485</b>
Limited Partner	148	<b>554</b>	154	159	164	165	<b>642</b>	166	166	<b>661</b>
<b>General Partner Share</b>										
Earnings	47%	<b>48%</b>	50%	53%	56%	56%	<b>54%</b>	56%	54%	<b>55%</b>
Distribution	42%	<b>41%</b>	42%	42%	42%	42%	<b>42%</b>	42%	42%	<b>42%</b>

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