

Rating: Sell
 S&P 500: 1278

Kinder Morgan Management LLC

Fading Returns, Rising Risk

<i>Symbol</i>	KMI	KMP	KMR	KMx
<i>Rating</i>	Sell	Sell	Sell	
<i>Price (US\$/sh)</i>	97.25	50.16	46.02	
<i>Pricing Date</i>	1/18/06	01/18/06	01/18/06	
<i>Publicly Held Shares (mm)</i>	139	144	44	
<i>Market Capitalization (US\$mm)</i>	13,600	7,230	2,040	22,900
<i>Debt (US\$mm)</i>	13,000	2,610	800	16,400
<i>Enterprise Value (EV) (US\$mm)</i>	26,600	9,840	2,840	39,300
<i>Present Value (PV) (US\$mm)</i>	17,600	4,780	1,470	23,900
<i>Net Present Value (US\$/share)</i>	33	15	15	
<i>Debt/Present Value</i>	0.74	0.55	0.55	0.69
<i>McDep Ratio - EV/PV</i>	1.51	2.06	1.94	1.65
<i>Ebitda Next Twelve Months ending 12/31/06 (US\$mm)</i>	2,150	610	185	2,940
<i>North American Natural Gas/Ebitda (%)</i>	0	0	0	
<i>Natural Gas and Oil Production/Ebitda (%)</i>	6	19	19	
<i>Adjusted Reserves/Production NTM</i>	6.3	6.3	6.3	
<i>EV/Ebitda</i>	12.3	16.3	15.3	13.3
<i>PV/Ebitda</i>	8.2	7.9	7.9	8.1
<i>Undeveloped Reserves (%)</i>	42	42	42	
<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	21.62	21.62	21.62	
<i>Present Value Proven Reserves(US\$/boe)</i>	19.08	19.08	19.12	
<i>Present Value Proven Reserves(US\$/mcf)</i>	3.18	3.18	3.19	
<i>Earnings Next Twelve Months (US\$/sh)</i>	5.00	2.05	2.05	
<i>Price/Earnings Next Twelve Months</i>	19	24	22	21
<i>Indicated Annual Distribution (US\$/sh)</i>	3.50	3.20	3.20	
<i>Distribution Yield (%/yr)</i>	3.6	6.4	7.0	4.8
<i>Ebitda by Function</i>				
<i>Natural Gas Pipelines</i>	1563	170	52	1785
<i>Oil Products Pipelines</i>	224	168	51	443
<i>CO2 Pipelines</i>	211	158	48	417
<i>Terminals</i>	152	114	35	300

Reported results may vary widely from estimates.

Estimated present value per share revised only infrequently.

Summary and Recommendation

Returns on sell-recommended **Kinder Morgan Inc. (KMI)**, **Kinder Morgan Energy Partners (KMP)**, and **Kinder Morgan Management LLC (KMR)** appear to be on a declining trend as the volatile commodity price environment up to 2000 has turned to a rising commodity price environment. Debt-adjusted returns for KMP and KMI have declined to about 11% and 5% per

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year respectively despite a strong energy environment. Competitive energy income stocks have returned on a comparable basis three to eight times those annual percentages. KMP returns appear to be suffering as a result of burdensome compensation to KMI and a costly hedge that gives away oil production for years at a price half current quote. Rich compensation from KMP is not enough to produce adequate debt-adjusted returns for KMI. Risks are rising with the accelerated need for new financing and the hint of regulatory change that may require cleaning up the accounting.

Fading Returns

It seems analysts and investors have been skeptical of royalty trusts among energy income stocks for more than 15 years. Management of Kinder Morgan emphasizes its commodity price insensitive strategy. During the late 1990s it seemed to work. Since then the return on KMx securities has fallen short of other energy income stocks. Of course the past does not tell the future. Yet the KMx record stops just after ten years while leading royalty trusts have a longer record.

The comparisons become starker when we take account of operating and financial leverage (see table Investor Total Return). For roughly 50% debt ratio KMP, an investor would own half as much for the same financial risk as in a no-debt stock. As a result the adjusted return after compounding is little more than half the raw return. For roughly 70% debt ratio KMI, the adjustment for financial leverage is more severe.

Investor Total Return (percent per year)

<u>Through 12/31/05</u>	<u>15 Years</u>	<u>10 Years</u>	<u>5 Years</u>
San Juan Basin Royalty Trust (SJT)	26.1	34.3	40.8
SBR adjusted for operating leverage	26.6	38.9	37.4
Sabine Royalty Trust (SBR)	22.2	32.4	31.2
Kinder Morgan Energy Partners (KMP)	na	31.6	18.5
Kinder Morgan Inc. (KMI)	na	19.4	14.3
KMP adjusted for financial leverage	na	23.6	10.8
KMI adjusted for financial leverage	na	9.4	5.1

Source: Bloomberg, McDep Associates

Rising Risks

Our concerns have found little voice at some bond rating agencies that seem to accept management's rationalization of a financial pyramid. Bond raters have been granted an oligopoly specifically to warn investors against unsound situations. The conflict is that the raters are paid by the companies that are rated.

Our concerns may be finding some voice at the financial accounting regulators. On the earnings call, management dismissed a reference to an apparent effort to require consolidation of the accounting statements for the three versions of the same company. The Financial Accounting Standards Board has an Emerging Issues Task Force dealing with consolidation of accounting for a general partner and limited partners.

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Investors who have large positions in KMx probably should try to understand what the regulators may do to pierce the KMx bubble. Proper accounting could trigger a loss of billions of dollars of stock market value and more realistic downgrading of debt.

Kinder Morgan also has ambitious expansion plans that may require an acceleration of financing. We fear that KMP is no longer competitive because its compensation to the general partner has exploded to 43% of all distributed cash. In other words new investors in KMP are being asked to put up 98% of the equity for a 57% share in the cash generated. It should be relatively easy for a competitive proposal with less onerous GP compensation to offer investors a better return.

The “heads we win, tails you lose” culture at KMP shows up in the earnings reported for the latest quarter. KMP reports net income of \$121.4 million on its official books. The general partner’s share is reported as \$125.6 million while the limited partners, the public unitholders, are stuck with a loss of \$4.2 million.

Theoretically, KMI is the beneficiary of the one-sided deal. Yet, the historical returns do not seem to bear that out. In any event we are skeptical that the artificial situation can be maintained. As a result we recommend the sale of each of the three KMx stocks.

Kurt H. Wulff, CFA

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

	<i>Q4</i>	<i>Q3</i>	<i>Q4</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Next Twelve Months</i>
	<i>12/31/04</i>	<i>9/30/05</i>	<i>12/31/05</i>	<i>2005</i>	<i>3/31/06</i>	<i>6/30/06</i>	<i>9/30/06</i>	<i>12/31/06</i>	<i>12/31/06</i>
Oil Volume									
Oil (mmb)	4.0	3.9	3.9	16	3.9	3.9	3.9	3.9	16
Oil (mbd)	43	42	43	43	43	43	43	43	43
Oil Price (\$/bbl)									
WTI Cushing	48.31	62.52	59.99	56.30	62.94	65.51	66.29	66.70	65.36
Partnership	28.12	28.98	30.22	29.43	30.59	30.90	30.99	31.04	30.88
Oil Revenue (\$mm)	112	112	119	465	118	120	122	122	483
Ebitda									
Products Pipelines	122	127	127	503	127	127	127	127	508
Natural Gas Pipelines	107	122	140	501	124	115	122	140	501
CO2 Pipelines	114	120	114	472	123	115	120	114	472
Terminals	67	82	85	319	85	85	85	85	340
Overhead	(51)	(53)	(52)	(238)	(52)	(52)	(52)	(52)	(207)
Total Ebitda	359	398	414	1,557	407	390	402	414	1,614
Deprec., Deplet., & Amort.	79	85	91	349	91	91	91	91	364
Ebit	280	313	323	1,208	316	299	311	323	1,250
Interest	54	68	68	262	68	68	68	68	272
Ebt	226	245	255	946	248	231	243	255	978
General Partner	107	123	126	478	130	131	131	132	524
Net Income (\$mm)	119	122	129	468	118	100	112	123	453
Units (mm)	203	214	219	213	220	221	222	223	221
Net Income Per Unit (\$/un)	0.59	0.57	0.59	2.20	0.54	0.45	0.50	0.55	2.05
Distribution Per L.P. Unit	0.73	0.78	0.79	3.07	0.80	0.80	0.80	0.80	3.20
Distribution (\$mm)	254	289	301	1,129	306	307	309	310	1,232
General Partner	106	122	128	476	130	131	131	132	524
Limited Partner	148	167	173	653	176	177	177	178	708
General Partner Share									
Earnings	47%	50%	49%	51%	52%	57%	54%	52%	54%
Distribution	42%	42%	42%	42%	43%	43%	43%	43%	43%

Kinder Morgan, Inc.
Next Twelve Months Financial Results

	<i>Q4</i>	<i>Q3</i>	<i>Q4</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Next Twelve Months</i>
	<i>12/31/04</i>	<i>9/30/05</i>	<i>12/31/05</i>	<i>2005</i>	<i>3/31/06</i>	<i>6/30/06</i>	<i>9/30/06</i>	<i>12/31/06</i>	<i>12/31/06</i>
Ebitda									
Natural Gas Pipelines	201	97	238	571	334	334	334	334	1,336
Kinder Morgan Energy Partners	182	202	210	789	206	198	204	210	818
Total Ebitda	383	299	448	1,361	540	532	538	544	2,154
Deprec., Deplet., & Amort.	30	30	42	131	66	66	66	66	264
Kinder Morgan Energy Partners	29	33	85	184	85	85	84	83	337
Ebit	324	236	321	1,045	389	381	388	395	1,553
Interest	39	45	69	199	120	120	120	120	480
Ebt	285	191	252	846	269	261	268	275	1,073
Income Tax	100	67	88	296	94	91	94	96	376
Net Income (\$mm)	185	124	164	550	175	170	174	179	698
Shares (millions)	125	123	127	124	139	139	139	139	139
Per Share (\$)	1.48	1.01	1.29	4.42	1.26	1.22	1.25	1.28	5.00
Tax Rate	35%	35%	35%	35%	35%	35%	35%	35%	35%

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

	Symbol/ Rating		Price (\$/sh) 18-Jan 2006	Adjstd Resrvs/ Prod NTM	PV/ Ebitda NTM	EV/ Ebitda NTM	P/E NTM	Divd or Distrib NTM (%)
Producer/Refiners - Large Cap and Mid Cap								
Kinder Morgan, Inc.	KMI	S2	97.25		8.2	12.3	19	3.6
Suncor Energy	SU	B	69.18	17.6	8.8	9.0	19	0.3
Imperial Oil Limited (30%)	IMO	B	103.00	11.5	7.0	8.4	14	0.8
Gazprom (50%)	OGZPF	B	85.00	20.0	11.0	7.9	14	0.5
Marathon Oil Corporation	MRO	B	71.12	7.4	5.1	5.4	8	1.9
Petro-Canada	PCZ	B	43.29	5.7	5.0	5.2	9	0.6
PetroChina Company Ltd (10%)	PTR	B	94.40	13.8	6.0	4.8	10	4.0
Norsk Hydro ASA	NHY	B	108.42	7.9	5.2	4.5	9	2.8
Lukoil Oil Company	LUKOY	B	72.05	19.7	5.9	4.3	6	1.4
	<i>Median</i>			<i>12.7</i>	<i>6.0</i>	<i>5.4</i>	<i>10</i>	<i>1.4</i>
Income								
Kinder Morgan Energy Partners, L.P.	KMP	S3	50.16		7.9	16.3	24	6.4
Kinder Morgan Management, LLC	KMR	S3	46.02		7.9	15.3	22	7.0
San Juan Basin Royalty Trust	SJT		43.60	12.2	9.3	10.1	11	9.0
Canadian Oil Sands Trust (US\$)	COSWF	B	124.74	20.0	10.8	10.0	12	2.8
Pengrowth Energy Trust	PGH		24.38	7.6	5.5	6.6	10	10.6
Enerplus Resources Fund	ERF		49.76	8.6	5.6	6.5	10	8.7
Penn West Energy Trust	PWTFF	B	35.76	8.0	4.9	6.1	9	8.9
	<i>Median</i>			<i>8.6</i>	<i>7.9</i>	<i>10.0</i>	<i>11</i>	<i>8.7</i>

EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended December 31, 2006; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses

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