

Energy Trusts and Partnerships

Presentation by
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Summary and Recommendation

- ♦ High Greed Partnerships Not a Good Deal
- ♦ Canadian Royalty Trusts fill a niche if restrained on debt and fees
- ♦ U.S. Natural Gas Royalty Trusts efficient for investor, but remain small

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Outline

- ♦ History
- ♦ Valuation
- ♦ Debt
- ♦ Fees
- ♦ Deception
- ♦ Opportunities

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Royalty Trusts (U.S.)

- ♦ Distribute all cash flow
- ♦ Fund development from cash flow
- ♦ Avoid corporate tax
- ♦ Income tax depends on amount distributed
- ♦ Cost depletion
- ♦ Non-Conventional Fuel Tax Credits

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Master Limited Partnerships

- ♦ General Partner has near unlimited discretion over distribution, operations and finance
- ♦ Avoid corporate tax
- ♦ Income tax depends on operations
- ♦ Cost depletion

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Energy Trusts and Partnerships Added to Research Coverage

- ◆ 1979
 - *Mesa Royalty Trust*
- ◆ 1980
 - *Permian Basin Royalty Trust*
 - *San Juan Basin Royalty Trust**
- ◆ 1982
 - *Houston Oil Trust*
- ◆ 1983
 - Apache Petroleum
 - Dorchester Hugoton*
 - *Freeport-McMoRan O&G R*
 - *LL&E Royalty Trust*
 - *Marine Petroleum Trust*
 - May Energy Partners
 - *Mesa Offshore Trust*
 - *Sabine Royalty Trust*
 - Transco Exploration Partners

*Continuing in coverage today

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Energy Trusts and Partnerships Added to Research Coverage

- ◆ 1984
 - Belden & Blake Energy
 - Entex Energy Development
 - McCormick O&G Partnership
 - Newhall Resources, Limited
 - OKC, Limited
 - Petroleum Investments, Ltd.
 - Snyder Oil Partners
 - *TEL Offshore Trust*
- ◆ 1985
 - *American Royalty Trust*
 - Consolidated Energy Partners
 - Convest Energy Partners
 - Damson Energy
 - Devon Resource Investors
 - Diamond Shamrock Offshore
 - Energy Development Partners
 - Enserch Exploration Partners
 - Freeport-McMoRan Partners
 - Graham-McCormick

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Energy Trusts and Partnerships Added to Research Coverage

- ◆ 1985 Continued
 - *Houston Oil Royalty Trust*
 - Kaneb Energy Partners
 - Lear Petroleum Partners
 - Mesa Limited Partnership
 - NRM Energy
 - Santa Fe Energy Partners
 - Saxon Oil Development
 - Sun Energy Partners
 - Union Exploration Partners
 - Walker Energy Partners
- ◆ 1986
 - Kelley Oil & Gas Partners
- ◆ 1989
 - *BP Prudhoe Bay RT*
 - Parker & Parsley
- ◆ 1990
 - Hallwood Energy Partners

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Energy Trusts and Partnerships Added to Research Coverage

- ◆ 1991
 - *Salomon Phibro Oil Trust*
- ◆ 1992
 - *Cross Timbers RT**
- ◆ 1993
 - *Williams Coal Seam Gas RT*
 - *BR Coal Seam Gas RT*
- ◆ 1995
 - *Dominion Resources Black Warrior Trust*
 - *Torch Energy Royalty Trust*
- ◆ 1997
 - *Athabasca Oil Sands Trust**
 - *Canadian Oil Sands Trust**

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Energy Trusts and Partnerships Added to Research Coverage

- ◆ 1999
 - *Hugoton Royalty Trust**
- ◆ 2001
 - AmeriGas Partners, L.P.
 - El Paso Energy Partners
 - Enbridge Energy Partners,
 - Enterprise Products Partners
- ◆ 2001 Continued
 - Kinder Morgan Energy Partners
 - Northern Border Partners
 - Penn Virginia Res. Part, L.P.
 - Plains All Amer. Pipeline
 - TEPPCO Partners, L.P.

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Energy Trusts and Partnerships Added to Research Coverage

- ◆ 2002
 - Alliance Resource Partners
 - *Enerplus Resources Fund*
 - *Pengrowth Energy Trust*
 - *Provident Energy Trust*

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Valuation – McDep Ratio

$$\text{McDep Ratio} = \frac{\text{Market Cap \& Debt}}{\text{Present Value}}$$

$$\text{Present Value} = \text{Ebitda} \times \frac{\text{PV}}{\text{Ebitda}}$$

Ebitda = Earnings before interest, tax, depreciation and amortization minus management fees minus financing fees

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Partnerships – McDep Ratios

	Symbol/ Rating		Price (\$/sh) 8-Jan 2003	Market Cap (\$mm)	McDep Ratio
El Paso Energy Partners	EPN	Sell	30.00	1,710	2.56
Kinder Morgan Energy Partners, L.P.	KMP	Sell	35.47	4,800	1.81
Kinder Morgan Management, LLC	KMR	Sell	32.04	1,270	1.68
Enbridge Energy Partners, L.P.	EEP	Sell	42.67	1,490	1.68
Plains All Amer. Pipeline	PAA		24.86	1,240	1.58
Enbridge Energy Management, L.L.C	EEQ	Sell	37.50	340	1.56
Northern Border Partners	NBP		37.76	1,660	1.32
TEPPCO Partners, L.P.	TPP		28.81	1,440	1.27

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Canadian RT's – McDep Ratios

	Symbol/ Rating	Price (\$/sh) 8-Jan 2003	Market Cap (\$mm)	McDep Ratio
Provident Energy Trust	PVX	7.00	450	1.31
Enerplus Resources Fund	ERF	17.95	1,350	1.00
Pengrowth Energy Trust	PGH	9.15	1,010	0.97
Canadian Oil Sands Trust (US\$)	COS_u_Buy	23.94	1,370	0.65

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US NatGas RT – McDep Ratios

	Symbol/ Rating	Price (\$/sh) 8-Jan 2003	Market Cap (\$mm)	McDep Ratio
Cross Timbers Royalty Trust	CRT	20.51	123	0.98
San Juan Basin Royalty Trust	SJT	13.66	640	0.79
Hugoton RoyaltyTrust (46%)	HGT	12.71	230	0.76

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Valuation - Distribution Growth

$$\text{Rate of Return} = \frac{\text{Distribution} + \text{Growth}}{\text{Unit Price}}$$

$$\text{Target Price} = \frac{\text{Distribution}}{\text{Target Yield}}$$

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Partnerships – Distributions

	Symbol/ Rating	Price (\$/sh) 8-Jan 2003	Div or Distrib. NTM (%)
Enbridge Energy Management, L.L.C	EEQ	37.50	9.6
El Paso Energy Partners	EPN	30.00	9.0
Plains All Amer. Pipeline	PAA	24.86	8.6
Northern Border Partners	NBP	37.76	8.5
Enbridge Energy Partners, L.P.	EEP	42.67	8.4
TEPPCO Partners, L.P.	TPP	28.81	8.3
Kinder Morgan Management, LLC	KMR	32.04	7.6
Kinder Morgan Energy Partners, L.P.	KMP	35.47	6.9

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Can RT's – Distributions

	<i>Symbol</i>	<i>Price (\$/sh) 8-Jan 2003</i>	<i>Div or Distrib. NTM (%)</i>
Provident Energy Trust	PVX	7.00	20.5
Pengrowth Energy Trust	PGH	9.15	16.5
Enerplus Resources Fund	ERF	17.95	13.0
Canadian Oil Sands Trust (USS)	COS_u.TO	23.94	5.4

NTM = Next Twelve Months

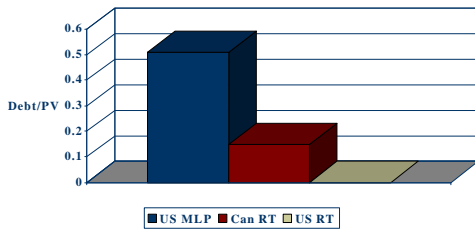
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US NGRT – Distributions

	<i>Symbol</i>	<i>Price (\$/sh) 8-Jan 2003</i>	<i>Div or Distrib. NTM (%)</i>
San Juan Basin Royalty Trust	SJT	13.66	12.4
Hugoton Royalty Trust (46%)	HGT	12.71	12.1
Cross Timbers Royalty Trust	CRT	20.51	10.6

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Debt



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Exploding Management Fees

- ◆ General Partner Takes:
 - 2% of Distribution
 - Plus 15% of Distribution above First Target
 - Plus 25% above Second Target
 - Plus 50% of Distribution above Third Target

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High Fee Achievers

	<i>Pyramid Levels (\$/unit)</i>			<i>Current Distrib. (\$/unit)</i>	<i>Average GP Share</i>
	15%	25%	50%		
Kinder Morgan (KMP,KMR)	0.15	0.18	0.23	0.61	40%
El Paso Energy Partners (EPN)	0.33	0.38	0.43	0.68	29%
TEPPCO Partners, L.P. (TPP)	0.28	0.33	0.45	0.60	26%
Enbridge Energy Part. (EEP,EEQ)	0.59	0.70	0.99	0.90	10%
Northern Border Partners (NBP)	0.61	0.72	0.94	0.80	7%
Plains All Amer. Pipeline (PAA)	0.45	0.50	0.68	0.54	6%

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Financing Fees

- ◆ Income an illusion if all cash paid out replaced by new financing
- ◆ Existing owners trade share of existing property for share of new property purchased with proceeds of financing
- ◆ Financing cost reduces value of existing owners position particularly if repeated

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Accounting Tricks

- ◆ “Incentive” distribution rights not on balance sheet
- ◆ Every deal an unreported loss for limited partners
- ◆ Computerized research overstates
- ◆ Human research overlooks
- ◆ Frequent acquisitions present opportunities to disguise trends
- ◆ Fee-based income can be manipulated
- ◆ Debt buried off balance sheet

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Debt Pyramids

- ◆ Partnerships off balance sheets of sponsors
- ◆ Debt/Ebitda
 - Kinder Morgan Inc. reported: 5.8x
 - Kinder Morgan Energy Partners reported: 4.0x
 - KM Inc. proportionally consolidated: 7.3x
- ◆ Ratings conditioned on more equity

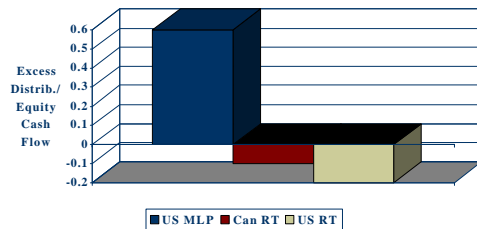
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Buy Long, Borrow Short

- ◆ Buy at, say, 8 times Ebitda
- ◆ Cash generated at 12.5% first year
- ◆ Finance with debt at, say, 7-10%
- ◆ Swap for low interest rates at, say, 3%
- ◆ Issue equity
- ◆ Raise distribution, mostly for GP
- ◆ Repeat

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Ponzi Payoffs



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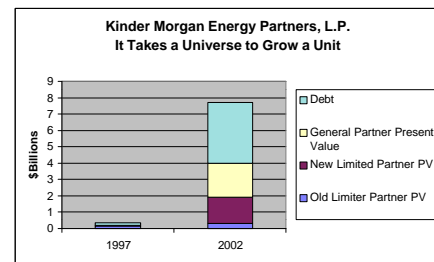
Ponzi Mechanics

1. Perpetrator collects money from investors on promise of high returns.
2. Returns a portion of money as “profit” while convincing investors to keep their principal invested.
3. Recruits new investors whose money is used to pay earlier investors.

Source: Walsh, “You Can’t Cheat an Honest Man”

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Growth Illusion



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Pyramid Investment Scheme Requires Exponential Growth

- ♦ One investor pays \$5,000 and recruits two more investors
- ♦ Two investors pay \$5,000 each and recruit four more investors
- ♦ Four investors pay \$5,000 each and recruit eight more investors
- ♦ Eight investors pay \$5,000 each; Perp pays first investor \$40,000, keeps \$35,000
- ♦ Need 15 investors for one to get paid

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Incentive Fallacy

- ♦ Incentive compensation a reward to General Partner for increasing distribution?
- ♦ Who benefits? Old unitholders and GP.
- ♦ Who pays? New unitholders.
- ♦ Coal partnerships abandon pretense that incentive “earned”

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Tax Analogy for GP Compensation

- ♦ High marginal rate – 50%
- ♦ Applies to income and principal
- ♦ No indexing for inflation

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Diminishing Returns

- ♦ Institutional PIK shares top out
 - Discount appears (KMR/KMP, EEQ/EEP)
 - Offering cancelled (EPN)
- ♦ Retail market saturated with high greed
- ♦ Debt ratings on or over the edge of junk
- ♦ Large partnership reduces take (EPD)
- ♦ Dividend taxation may be reduced

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Opportunities

- ♦ Investors
 - Buy selectively
 - Sell highest greed partnerships
- ♦ Issuers
 - Market low debt, low fees
 - Restructure high debt, high fees
 - Minimize deception

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Can RT Pros and Cons

- ♦ Valuation more reasonable
- ♦ Debt more reasonable
- ♦ Less aggressive management fees
- ♦ High financing cost
- ♦ Moving targets for investment analysis because of frequency of deals

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Canadian Oil Sands Trust

- ♦ Growing volume
- ♦ Extraordinarily long life
- ♦ Low management fees
- ♦ Low financing fees
- ♦ Potential environmental cost

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San Juan Basin Royalty Trust

- ♦ Long life
- ♦ No management fees
- ♦ No financing fees
- ♦ Clean fuel environmental advantage
- ♦ Limited market cap

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Energy Trusts and Partnerships Conclusion

- ♦ Investors have high demand for income
- ♦ Market does not appear to discriminate well initially between efficient income opportunities and high debt, high fee promotions
- ♦ High greed partnerships not a good deal
- ♦ U.S. royalty trusts efficient, but small
- ♦ Canadian royalty trusts potentially attractive alternative if debt and fees restrained

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