Rating: Sell
S&P 500: 914

Enbridge Energy Partners, L.P.
Enbridge Energy Management, L.L.C
High Valuation, High Debt, Dubious Compensation

Symbol	*Price ($/sh) 20-Nov 2002*	*Shares (mm)*	*Market Cap ($mm)*	*Net Present Value ($/sh)*	*Debt/ Present Value*	*McDep Ratio*	*EV/ Sales 2001E*	*EV/ Ebitda NTM*	*P/E NTM*	*Distrib. NTM (%)*	*PV/ Ebitda NTM*
EEP	38.97	35	1,360	14.90	0.64	1.58	1.9	14	29	9.2	9.0
EEQ	34.70	9	310	14.90	0.64	1.48	1.7	13	26	10.4	9.0

McDep Ratio = **M**arket **c**ap and **De**bt to **p**resent value of oil and gas and other businesses		
EV = Enterprise Value = Market Cap and Debt:	$mm	2,820
Ebitda = Earnings before interest, tax, depreciation and amortization:	$mm	200
NTM = Next Twelve Months Ended March 31, 2003; P/E = Stock Price to Earnings		
PV = Present Value of energy businesses:	$mm	1,803

Summary and Recommendation

We recommend sale of the units of Enbridge Energy Partners and the shares of Enbridge Energy Management on the basis of high McDep Ratio, high ratio of debt and a high greed partnership structure. Valuable ownership of an oil pipeline from Canada to Chicago has been diluted by the addition of unrelated natural gas gathering assets dumped into the partnership by the owner of the general partner. To partially finance the conflicted transaction, a novel payment-in-kind security of a new entity, Enbridge Energy Management, was sold to unenthusiastic buyers. Both EEP and EEQ appear to be some 50% overvalued on an unlevered basis as measured by the McDep Ratio. On a levered basis EEP and EEQ appear more than 150% and 120% overvalued. High debt at 5.7 times cash flow leaves little solvency cushion below where recent acquisitions appear to have been priced. Questionable deals and marginal financing tactics appear to be driven by high greed general partner compensation popularized by Enron, Kinder Morgan, El Paso, and Duke Energy among others. The risk is that cyclical factors seem to favor improving stock prices generally for a while. Moreover influential parties promote high-greed partnerships in a relatively inefficient market where stock price could readily be driven higher temporarily.

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Recent Transaction Clouds Estimates

We don't pretend to have a rigorous projection of results by segments, as management has not yet disclosed sufficient accounting detail since an $820 million acquisition closed only last month. Yet valuation and leverage are so high that it is unlikely that results to be incurred in the future will be sufficiently better to change our conclusion. With that qualification we adjust the actual results for the quarter just ended to form a basis for annualizing at a different level (see Table).

Enbridge Energy Partners, L.P.
Next Twelve Months Financial Results

	Q3	*Q4E*	*Q1E*	*Q2E*	*Q3E*	*Q4E*	***Next Twelve Months***
	9/30/02	*12/31/02*	*3/31/03*	*6/30/03*	*9/30/03*	*12/31/03*	*12/31/03*
Revenue ($mm)	237	487	487	487	487	487	**1,948**
Expense	188	423	423	423	423	423	**1,693**
Ebitda	49	64	64	64	64	64	**255**
Deprec., Deplet., & Amort.	18	26	26	26	26	26	**104**
Ebit	31	38	38	38	38	38	**151**
Interest	13	19	19	19	19	19	**76**
General Partner	3	4	4	4	4	4	**16**
Net Income ($mm)	15	15	15	15	15	15	**59**
Units (millions)	35	44	44	44	44	44	**44**
Per Unit ($)	0.42	0.33	0.33	0.33	0.33	0.33	**1.34**
Ebitda Margin	21%	13%	13%	13%	13%	13%	**13%**
Share of Income							
General Partner	17%	21%	21%	21%	21%	21%	**21%**
Limited Partners	83%	79%	79%	79%	79%	79%	**79%**

Half of Distribution Paid Out of Capital

Paying dividends or distributions out of capital instead of income is a time-honored technique for misleading investors into paying too much for a security. When Mr. Ponzi gave immigrants in Boston high distributions from their own principal, they apparently thought the "investments" were highly productive and rushed to put in more. General partners of high-greed entities seem to have honed the technique to new levels of sophistication.

EEP currently pays $0.90 per quarter. EEQ would make payment-in-kind (PIK) in the form of new shares to existing shareholders. The total value distributed would be $40 million in three months. In contrast, let us see how much cash flow is allocable to the limited partners. Multiplying quarterly Ebitda of $64 million by the ratio of debt to present value of 0.64 and subtracting that amount leaves just $23 million. Multiplying

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that remainder by the share of income going to the general partner of 21% and subtracting that amount leaves just $18 million. As a result, it seems that $22 million, or more than half of the $40 million distribution is being paid out of capital.

Contrast Distribution Yield With Strips, Not the T-Note

The most prominent valuation technique applied to the partnerships by those who recommend purchase appears to be to compare the distribution yield to the yield on the U.S. Treasury Ten-Year Note. Thus the 9.4% distribution yield on EEP appears compellingly attractive compared to 4.0% currently on the "risk-free" alternative.

We suggest a modification. In our opinion all the unitholders are likely to get over ten years is the distribution. The general partner is likely to skim practically all the upside through the unbalanced compensation scheme. Then at some point the debt holders may shut the thing down and take all the remaining assets to satisfy their claim.

Similarly, brokers that deal with the Federal Reserve are allowed to divide Treasury Notes into "strips". One party might get the income like the unit holder and another party might get the principal like the debt holder. One fine distinction, the apparent distribution yield on the income strip is much higher than 4.0%. It would be about 12%. Why take the risk of investing in a high greed partnership when one can get 12% distribution yield on a ten-year strip supposedly guaranteed by the Federal Government?

High McDep Ratio Implies Sell

Highlighting how much the distribution is paid out of capital and comparing yields to strips are new ways to communicate the overvaluation that seems readily apparent from our McDep analysis. The McDep Ratio is the most important single valuation measure for energy stocks, in our experience. The numerator, "McDe" in McDep, is Market Cap and Debt, also known as Enterprise Value. The denominator, "p" in McDep, is Present Value of future cash flow from natural gas and oil production and other businesses. Stocks with high McDep Ratios, especially those above 1.20, have high valuation risk and are likely to underperform. Stocks with low McDep Ratios, especially those below 0.8 have extra appreciation potential.

McDep Ratio Numerator Neutralizes Financial Leverage

Promoting value without disclosing or simply ignoring leverage has long been done to deceive investors well before Enron came along. By combining market cap and debt in the numerator of the McDep Ratio we look at value before leverage. Admittedly we can still be fooled when leverage is not fully disclosed.

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After identifying attractive value, investors can add their own leverage by adjusting amounts owned of high and low debt stocks, or if possible, sell short or buy on margin. Where investors have some flexibility it makes little sense to invest in a stock with excessive debt.

McDep Ratio Denominator Measures Fundamental or Business Value

The commonly accepted technique for valuing capital-intensive energy businesses has long been discounted cash flow analysis. In recent years the techniques of real options valuation and mathematical simulation have been gaining attention. We discount expected cash flows the old-fashioned way for now and keep in mind the possible implications of "upside" and contingent claims. We mostly ignore near-term hedging of prices and prefer to pretend that value depends on market realizations instead of the results of hedging.

Moreover we try to estimate value mostly independent of future discretionary decisions. We give credit for quality of management to the extent it is already reflected in choice of assets and current revenues and costs. For the most part we ignore quality of future management decisions by assuming the same rate of return to be earned from comparable assets regardless of the people managing those assets. In that sense apparent undervaluation or overvaluation of an asset by the McDep Ratio is an indirect measure of the regard that investors hold for the managers of the asset. Each investor can question whether that regard held by other investors is justified.

Value Energy Assets on a Multiple of Cash Flow

While we say our technique is tied to discounted cash flow analysis we necessarily shorten the process when applying it to more companies. The simple model is that present value equals next twelve months cash flow (Ebitda) times a multiple that reflects asset life primarily. It is simple logic that the longer an asset lasts, the longer cash flow lasts. We make a modification to asset life that counts undeveloped assets at lower weight because development costs yet to be spent subtract from present value of future cash flow. Factors to consider in assessing a multiple could be anything that would affect the present value calculation.

McDep Technique Exposed the Weakness of Energy Infrastructure Stocks

Valuing major oil stocks at nine times cash flow, we reckoned why pay more for an energy infrastructure stock. Pegging the value of pipelines, terminals and power plants at oil company multiples gave high McDep Ratios and high ratios of Debt/Present Value a year ago. Since then most McDep Ratios have come down to more reasonable levels while debt remains high. In many cases, cash flow was not what it seemed to be and values declined as well, propelling ratios of debt to failure levels.

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McDep Ratio Flags Energy Partnerships and Uncovers "High Greed"

About a year ago we began to extend the McDep analysis to energy infrastructure partnerships, a fast growing category of new capital raising entities. High McDep Ratios and high ratios of debt aroused our concerns. Then as we learned more about how general partner compensation worked we became convinced that the leading entities had reached the point of diminishing returns and had become vulnerable to losing market recognition.

Avoid Excessive Debt

The next most important valuation consideration is the ratio of Debt/Present Value. Stocks with ratios of debt above 0.50 have a high probability of financial failure and are to be avoided, in our opinion, regardless of McDep Ratio. Of eleven stocks in our coverage a year ago with debt above 0.50, eight have essentially failed or gone bankrupt.

Assets May Barely Exceed Liabilities

Much of the energy infrastructure industry today seems well along on the path of debt deflation. Financial failures have put assets on the market. The lack of well-capitalized buyers has driven down asset prices further. Companies heretofore considered healthy are now under surprising pressure.

Here is how the numbers might work for EEP. We calculate a debt to cash flow multiple, Debt/Earnings Before Interest, Tax and Depreciation (Ebitda). Take debt after October transactions at $1458 million for the whole entity including EEP, EEQ and the General Partner and dividing by $255 million we get 5.7 times.

We assess Present Value at 9.0 time cash flow. That could be generous. Some suggest the going market for energy infrastructure properties may be about six to seven times cash flow. On that basis if EEP's existing assets are worth the same as new acquisitions, then EEP's debt at 5.7 times cash flow is exceeded by the value of EEP's assets by only a slim margin.

Experience tells us when confidence slips, the perceived value of a company's assets can fall rapidly. Stocks with high ratios of debt are particularly vulnerable to a loss of confidence.

Supply and Fees Weigh on Partnership Securities

Around the time EEQ raised $333 million in an initial public offering, El Paso withdrew its proposed offering of $600 million of partnership securities. EEQ was sold into a market that seemed saturated with similar derivative securities. Kinder Morgan initiated

the derivative more than a year ago with a billion dollar offering. Then investors started to look more closely. A follow-on offering was completed just before the EEQ offering more than six months late and 70% short of expectations.

The high fees charged by the general partner may be giving new investors pause. There is good reason why we label the partnerships as high greed. We have further likened them to Ponzi schemes and pyramid frauds. The tendency to pay existing unitholders in part with the proceeds of new offerings reminds us of Carlo Ponzi.

The fee structure of high greed partnerships looks like that of a pyramid fraud (see Table). The general partner creates a new entity with a conservative payout and charges the initial limited partners 2%. Then the payout is boosted to what may be less conservative levels. The unit price hopefully goes up with the payout. The general partner charges 15%. New money is raised at the higher unit price and the proceeds used to acquire additional assets whose cash flow and principal support another increase in payout. The unit price hopefully goes up again. The general partner now charges 25%. New money is raised at the higher unit price and the proceeds used to acquire additional assets whose cash flow and principal support another increase in payout. The unit price hopefully goes up again. The general partner now charges 50%.

High Greed Partnerships

	Pyramid Levels ($/unit)			*Current Distrib.*	*Average*	*Greed*	*Potential "Ponzi Perp"*
	15%	*25%*	*50%*	*($/unit)*	*GP Share*	*Gauge*	*aka General Partner*
Kinder Morgan (KMP,KMR)	0.15	0.18	0.23	0.61	**40%**	2.61	Kinder Morgan (KMI)
El Paso Energy Partners (EPN)	0.33	0.38	0.43	0.68	**29%**	1.59	El Paso (EP)
TEPPCO Partners, L.P. (TPP)	0.28	0.33	0.45	0.60	**26%**	1.33	Duke(DUK)/Phillips (P)
Enbridge Energy Partners (EEP)	0.59	0.70	0.99	0.90	10%	0.91	Enbridge Inc. (ENB)
Northern Border Partners (NBP)	0.61	0.72	0.94	0.80	7%	0.86	Enron, Williams (WMB)
Enterprise Products Part. (EPD)	0.25	0.31	0.39	0.34	7%	0.85	RD/Shell (RD) (20%)
Plains All Amer. Pipeline (PAA)	0.45	0.50	0.68	0.54	6%	0.80	Plains Resources (PLX)
Williams Energy Partners (WEG)	0.58	0.66	0.79	0.68	5%	0.86	Williams (WMB)
Valero LP (VLI)	0.60	0.66	0.90	0.70	4%	0.78	Valero Energy (VLO)
Penn Virginia Res. Part, L.P.(PVR)	0.55	0.65	0.75	0.50	2%	0.67	Penn Virginia (PVA)
Alliance Res. Part, L.P.(ARLP)	0.55	0.63	0.75	0.50	2%	0.67	Managers
Pacific Energy Partners (PPX)	0.51	0.59	0.70	0.46	2%	0.66	Anschutz
AmeriGas Partners, L.P. (APU)	0.61	0.70	0.90	0.55	2%	0.61	UGI Corporation (UGI)
Suburban Propane Prs, L.P. (SPH)	0.55			0.58	2%	na	Managers
Genesis Energy, L.P. (GEL)	0.25	0.28	0.33	0.00		0.00	Denbury Resources (DNR)
EOTT Energy Part., L.P. (EOT)	0.53	0.63	0.73	0.00		0.00	Enron
Natural Resource Partners (NRP)	0.56	0.66	0.76				

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We list the pyramid levels for well-known schemes. It is immediately apparent that EEP is approaching the fourth level of the pyramid as its current quarterly distribution nears the pyramid level above which the general partner extracts 50% of distributions incrementally. EEP still has a way to go to match the greed of industry leaders. Yet the very existence of highest greed compensation potential may promote dysfunctional activity such as excessive leverage and unsuitable acquisitions.

Another implication is that high greed partnerships do fail. Bankruptcy of the general partner, Enron, contributed to limited partner loss in EOTT. Genesis failed even before advancing beyond the first pyramid level. No problem, a new general partner was installed and the pyramid levels were reset at vastly easier levels to achieve. Limited partners lost some 80% of their value in the first failure of Genesis and seem at risk to lose the rest in the new form.

We like fees, too, but there has to be a bound to what responsible professionals would charge. In the end that bound is the marketplace. Limited partners can protect themselves by selling while there is still a lot of support for unit price.

Take Your PIK

We have referred to EEQ as a payment-in-kind (PIK) financing. While EEP is the fourth greediest of 21st Century energy infrastructure partnerships, it is only the second to have a PIK. Instead of being paid cash in the amount of the distribution on EEP, EEQ holders get new units of EEQ equivalent to the cash. Innocuous as that may seem, it is a sign of deteriorating financial quality, in our opinion. PIK financing was common among failed partnerships a decade ago. Once the stock price starts to decline for a company with PIK financing it may be a death spiral. Lower price means more shares issued to satisfy PIK requirements and more shares means lower price because of dilution.

Exchange Right Omitted

The first high greed PIK by Kinder Morgan had an exchange right that allowed institutional investors being sold the PIK to exchange their PIK shares for the cash paying shares favored by taxable individuals at any time. The PIK allowed institutions to bet whether individuals would continue to pay a high price for partnership units. Yet shareholders of the PIK own only a shell that owns units of the partnership. After the exchange right was withdrawn, the Kinder Morgan PIK promptly traded at a discount to the cash paying units. Without an exchange right, the EEQ offering followed true to form coming to market at a discount to EEP and keeping that discount.

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Opportunities in Income Stocks

We don't like appearing to be negative. Yet we dislike losing money even more. Our experience tells us that except for the fleet footed, high McDep Ratios and high ratios of debt are paths to losing money for energy equity investors.

Nor are we negative on partnerships or on fees. We are negative on high greed partnerships. We see no justification for exploding percentage fees that ultimately become among the most excessive in any business situation. Those partnerships that are not yet in "the high splits", as the pirates like to say, could greatly enhance their investment appeal, in our opinion, by revising their compensation deals to a simple percentage at a reasonable level. Income obviously appeals to investors. Honest income is the kind we would like to encourage.

Kurt H. Wulff, CFA

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