McDep Associates
Independent Stock Idea
August 16, 2002

Buy/Sell Rating: 4-Sell
S&P 500: 930

El Paso Corporation
High Debt, High Greed

Symbol	*Price ($/sh) 15-Aug 2002*	*Shares (mm)*	*Market Cap ($mm)*	*Net Present Value ($/sh)*	*Debt/ Present Value*	*McDep Ratio*	*EV/ Sales NTM*	*EV/ Ebitda NTM*	*P/E NTM*	*Div'd NTM (%)*	*PV/ Ebitda NTM*
EP	15.88	590	9,400	20.00	0.66	0.93	2.7	7.4	10	5.5	7.9

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:	US$mm	32,100
Ebitda = Earnings before interest, tax, depreciation and amortization:	US$mm	4,340
NTM = Next Twelve Months Ended June 30, 2003; P/E = Stock Price to Earnings		
PV = Present Value of energy businesses:	US$mm	34,500
Present Value of Equity:	US$mm	11,800

Summary and Recommendation

We recommend sale of the shares of El Paso Corporation (EP) because the company's strategy to use a high greed partnership to reduce excessive debt appears unsound to us. We are nervous about making a sell recommendation because we like El Paso's energy infrastructure assets that appear to be priced at a reasonable McDep Ratio and the stock is down some 75% since we reestablished coverage in May 2001. Yet we are confident we do not want the excessive open and hidden debt of El Paso when high debt entities are deflating. We are highly confident we do not want equity representation in the sponsor of a high greed partnership reaching the point of diminishing returns. We have a Strong Sell rating on El Paso Energy Partners (EPN), a related entity shamelessly promoted by El Paso. In particular we are skeptical that a newly proposed offering of derivative partnership securities of EPN will be well received. Should the stock do well despite our concerns, investors who sell would still participate in the upside of energy at less risk and with more peace of mind in our buy recommendations. Finally, for any high debt stock like El Paso, it does not take much change in Present Value to have a magnified impact on stock price up or down.

Supply and Fees May Weigh on Partnership Securities

A preliminary registration statement has been filed with the Securities and Exchange Commission covering the proposed offering of $600 million of partnership securities. A new entity, El Paso Energy Management LLC, would issue shares primarily to institutional buyers. Management is a misnomer, as the entity would manage nothing. A more descriptive name would be El Paso Institutional Derivatives. The new entity would own limited partner units in El Paso Energy Partners, L.P. The hope, apparently, is that the new entity would attract institutional capital that would not otherwise want the tax consequences of a limited partnership.

The contemplated offering would be made in a market that may be 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 recently more than six months late and 70% short of expectations. Enbridge has also filed for an offering of similar derivative units.

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. Apparently Mr. Ponzi changed his name to Charles as he is more commonly remembered (see Walsh, James, "You Can't Cheat an Honest Man – How Ponzi Schemes and Pyramid Frauds Work").

High Greed Partnerships

	Pyramid Levels ($/unit)			*Current Distrib.*			
	15%	*25%*	*50%*	*($/unit)*	*Average GP Share*	*Greed Gauge*	*Potential "Ponzi Perp" 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)
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

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 carefully selected for early cash returns to 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 carefully selected for early cash returns to support another increase in payout. The unit price hopefully goes up again. The general partner now charges 50%.

We list the pyramid levels for well-known schemes. It is immediately apparent that El Paso has reached the fourth level of the pyramid as its current quarterly distribution exceeds the pyramid level at which the general partner extracts 50% of distributions incrementally. Moreover, the acquisitions that El Paso is jamming into its partnership are likely to be used to justify raising the average 29% fee asymptotically to 50%.

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 destined to lose the rest in the new form.

New Investors Enter At The Top Pyramid Level

Perhaps it is telling that El Paso has turned to institutional investors for incremental funding. If individuals have many choices to enter other partnerships at lower pyramid levels, why should they enter at a high level? Instead EP, the general partner of EPN, is asking institutional investors to pay an immediate fee of 29% on average and 50% incrementally of all income and principal distributed. Yet, we ask, do workers want their pension fund managers making such investments? Do mutual fund investors want their fund managers making such commitments?

The counter argument is mainly that the pyramid can keep going. The most vociferous voices making that argument are likely limited partners that got in early or general partners and investors in general partners that are on the other side of those fees. General partners are likely to downplay their greed and to make hypocritical claims that their interests are aligned with unitholders.

We like fees, too, but there has to be a limit to what responsible professionals would charge. In the end that limit is the marketplace. Limited partners need to think independently and to be wary of the propaganda from high greed general partners like El Paso. The best protection that limited partners have is to sell while there is still a lot of support for unit price. Thus, because we have concerns about the investment value in El

Paso Energy Partners, it is hard for us to be confident about the investment value in El Paso Corporation.

Rising Fear of Deflation Implies Avoiding High Debt

Steeply declining yields on U.S. Treasury Bonds and Notes appear to be foretelling deflationary economic conditions. We do not expect the worst fears to be realized, but we think the trend to deflation of debt, i.e. the failure of high debt entities, whether they are companies or individuals, is likely to continue and may accelerate. In that context we believe investors should minimize their exposure to high debt companies like El Paso.

After the McDep Ratio, the second most important financial ratio is that for Debt/Present Value. El Paso has the highest ratio of debt among Large Cap stocks in our coverage. Actually the stock is in danger of being reclassified as Mid Cap as has already occurred for Kinder Morgan, Williams, Calpine, AES, Mirant and Dynegy.

Diversified investors who want the leverage of debt can make that decision for themselves. Some might simply increase the weighting of favored low debt stocks. Others might reduce cash reserves or actually borrow to buy additional shares in low debt stocks. At least the investor retains control of the leverage decision.

At El Paso, the momentum of the 1990s carried debt to an unsustainable level. Management is scrambling to adjust to market preferences that are changing too fast. Our concern about El Paso's vulnerability to merciless debt deflation is heightened by announcement of the company's intention to rely on a questionable refinancing through a high greed partnership. The two factors together are enough reason for us to recommend sale of El Paso stock even after the steep decline that has already taken place.

Bankruptcy Beckons

A bad scenario is playing out. The outlook for El Paso stock may be more sensitive to leverage than to valuation. We have seen valuation for energy infrastructure properties drop by perhaps a third. Yet we are still estimating Present Value for El Paso at 8 times cash flow compared to 9 earlier. We can make reasonable estimates for cash flow for EP's natural gas production on the basis of physical quantities. We are less certain about the actual level of the company's overall cash flow not knowing what kind of financial arrangements have shifted realizations into the future or brought them forward. We have found with peer companies that reported cash flow sometimes has not been there. Because we use cash flow as an indicator of value, lower cash flow can lead to a lower estimate of value. If our current estimate of El Paso's gross present value were to drop by a third, net present value would become zero. All those fine assets that we hoped would save El Paso would be entirely offset by debt.

Moreover debt is understated to the extent that the company is a pyramid of debt. We only count the first level. Apparently EP does not include the debt of EPN on its balance sheet. Apparently EPN does not include the debt of further pyramid investments on EPN's balance sheet.

Rating Agency Turns Negative

As we understand history, the debt rating agencies were formed 70 years ago to save investors from the destruction of the debt pyramids in the energy infrastructure industry. Certain bond analysts are allowed inside information for the exclusive purpose of rating an issuers debt. Unfortunately the raters are conflicted because the issuer pays them. Moreover the analysts often get to know management quite well over the years. We can imagine the pressures on a bond analyst to avoid making a rating as negative as it should be. As a result the system that was designed to protect investors may be co-opted.

Despite the obvious pressures on bond analysts to be positive, we take special note that Moody's on August 14 issued a more negative statement on El Paso. We would expect further reaction when an event occurs such as the outcome of a financing.

Finally government investigations are in progress. Moody's calls attention to regulatory proceedings and investigations that could potentially have a material impact. While we hope there will be no further negative revelations, we remain concerned. We have only to observe the widespread embrace of high greed partnerships to raise doubts about the intentions of companies that sponsor them.

How Times Have Changed

About 20 years ago, El Paso was one of our favorite buy recommendations. About 15 years ago we enjoyed a ride by jet from El Paso, Texas, to the San Juan Basin of Northwest New Mexico with the person who is chief executive officer today. We have covered and expressed opinions on other natural gas pipeline companies that are now part of El Paso including Sonat, Tenneco and Coastal. Thus we do not wish to appear disloyal when we recommend sale of El Paso stock, but feel our first responsibility is to the investors who are our clients.

We would like to find a way to capitalize on the depression in value of infrastructure assets. Among our recommended stocks, we think Chevron might have done more to keep a share of the value that Warren Buffet captured when he bought Northern Natural Gas from Chevron-controlled Dynegy. We liked it better when recommended Encana was the buyer of assets unwillingly sold by Williams.

Kurt H. Wulff, CFA

El Paso Corporation
Next Twelve Months Operating and Financial Estimates

	Q2 6/30/01	*Q3 9/30/01*	*Q4 12/31/01*	***Year 2001***	*Q1 3/31/02*	*Q2 6/30/02*	***Year 2002E***	***Next Twelve** Months 3/31/03*
Volume								
Natural gas (bcf)								
Total	139	146	145	**564**	133	120	**498**	**490**
Oil (mmb)	3.4	3.6	4.3	**14.4**	5.0	5.0	**20.2**	**20.3**
Total gas & oil (bcf)	159	167	171	**650**	163	150	**620**	**612**
Price								
Natural gas ($/mcf)								
Henry Hub ($/mmbtu)	4.36	2.75	2.41	**3.96**	2.53	3.38	**3.07**	**3.44**
Total	3.49	3.46	3.33	**3.44**	2.13	2.98	**2.66**	**3.04**
Oil ($/bbl)								
WTI Cushing	27.88	26.69	20.40	**25.95**	21.60	26.27	**25.57**	**26.52**
Worldwide	22.98	21.62	16.58	**21.69**	15.68	22.14	**20.94**	**22.35**
Revenue ($mm)								
Natural Gas								
Total	486	505	483	**1,942**	283	357	**1,324**	**1,488**
Oil	77	77	72	**312**	78	111	**423**	**453**
Other	12,800	13,263	11,560	**54,824**	12,826	2,519	**20,383**	**10,075**
Total	13,363	13,845	12,115	**57,077**	13,188	2,987	**22,130**	**12,016**
Expense								
Fixed	84	88	89	**394**	89	89	**355**	**355**
Variable	84	88	89	**394**	58	82	**300**	**340**
Other	11,925	12,411	10,650	**51,075**	11,603	1,745	**16,839**	**6,981**
Ebitda ($mm)	1,271	1,259	1,287	**5,214**	1,438	1,071	**4,636**	**4,341**
Deprec., Deplet., & Amort.	333	346	354	**1,359**	375	352	**1,431**	**1,408**
Ebit								
Exploration and Production	296	307	277	**1,065**	209	241	**916**	**1,020**
Other	642	606	656	**2,790**	854	478	**2,288**	**1,912**
Total	938	913	933	**3,855**	1,063	719	**3,205**	**2,933**
Interest	291	279	290	**1,155**	307	359	**1,384**	**1,436**
Ebt	647	634	643	**2,700**	756	360	**1,821**	**1,497**
Income Tax	226	222	225	**945**	265	126	**637**	**524**
Net Income ($mm)	420	412	418	**1,755**	491	234	**1,183**	**973**
Shares (millions)	532	528	529	**529**	546	532	**559**	**590**
Per share ($)	0.79	0.78	0.79	**3.32**	0.90	0.44	**2.12**	**1.65**
Ebitda Margin	10%	9%	11%	**9%**	11%	36%	**21%**	**36%**
Tax Rate	35%	35%	35%	**35%**	35%	35%	**35%**	**35%**