McDep Associates
Stock Idea
February 20, 2002

Buy/Sell Rating: 5 – Strong Sell

El Paso Energy Partners, L.P.
High McDep Ratio and High Reading on the Greed Gauge

Symbol	Price ($/sh) 20-Feb 2002	Shares (mm)	Market Cap ($mm)	Net Present Value ($/sh)	Debt/ Present Value	McDep Ratio	EV/ Sales 2001E	EV/ Ebitda NTM	P/E NTM	Div'd NTM (%)	PV/ Ebitda NTM
EPN	34.97	36	1,260	7.90	0.50	2.71	19	24	49	7.1	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	1,540
Ebitda = Earnings before interest, tax, depreciation and amortization:	$mm	60
NTM = Next Twelve Months Ended March 31, 2003; P/E = Stock Price to Earnings		
PV = Present Value of energy businesses:	$mm	570
Present Value of Equity:	$mm	290

Summary and Recommendation

We strongly recommend sale of the limited partner units of EPN because the structure of the partnership and the process of marketing it to investors are questionable. The confusing practices are not confined to **El Paso Corporation (EP)**, the general partner of EPN, but have been sharply honed by **Kinder Morgan (KMI, KMP, and KMR)** and are being emulated by **Williams Companies (WMB)** and even **Duke Energy (DUK)**. Typically assets are transferred to a partnership at an artificial price with the transferor retaining a disguised half economic interest. The marketing to investors is distorted because Wall Street underwriters who derive their compensation from transaction fees overstate valuation and understate risk. Thus it appears that the corruption of Enron has tentacles through the energy infrastructure industry and its related elements in the financial services industry. Until it is rooted out we recommend that investors avoid the limited partner units of EPN. Those qualitative reasons are further supported by quantitative analysis that leads to a high McDep Ratio and a high reading on the Greed Gauge.

We Know It When We See It

While we may be having trouble describing the questionable justification of partnerships like EPN, we have tried by writing for the past two months on a similar situation at Kinder Morgan. (To see our historical analysis log on to www.mcdep.com, click on a

gold box labeled Stock Ideas. Then click on a gold box labeled KMI or KMP or KMR for references to past analyses. Then click on any or all of the references.) While focused primarily on Kinder Morgan, our past analyses include references to El Paso, Williams, Duke and others.

Asset Transfer Heavily Conflicted

The collapse of Enron was largely about partnerships to hide debt and unjustifiable compensation. That Enron's competitors also have debt problems is becoming widely known as stock prices are collapsing almost as much as for Enron (see *Meter Reader*, McDep Ratio Hinted at Power Stock Collapse, February 18, 2002). In a small step to help alleviate debt at EP, a Texas intrastate natural gas pipeline is being transferred to EPN. The transferee expects to pay for the asset with the proceeds of new limited partner equity securities and debt that will not show on the books of the transferor.

The price of the transfer is set entirely by El Paso who is both the seller and the general partner of the buyer. El Paso is a forced seller considering its debt load. Because it gets a kickback through the general partner, EP wants to be sure that only the preferred "buyer" is on the other side of the transaction.

Partnership Pays Excessive Compensation

The predecessor of EPN was formed with a compensation agreement that provided for "incentives" to the general partner for distributions above trigger levels. Thanks mainly to rapid growth through deals, the general partner gets 26% of all cash distributed at the current $2.50 per unit annual rate and 50% of any cash distributed at any increment to that rate. El Paso apparently has a backlog of future asset transfers that will be increasingly lucrative as the general partner kickback asymptotically approaches 50%.

Already the general partner gets 44% of reported earnings. We would interpret share of earnings as a leading indicator of share of value. In extreme cases the general partner share of value may exceed 50%.

Deals are typically front-end loaded in that the properties generate more cash in their early years than in their later years. The more deals a partnership does, the better its cash flow looks for a while and the more compensation paid to the general partner.

When the deals stop, the cash flow starts to decline within a short time. Then the limited partners will be left with a long, long period to recover their investment. Because the general partner makes no investment, all its income is gravy, so to speak. A few partnerships have failed, but for the most part the current wave of partnership abuse is still early in its life and relatively unexposed.

Excessive Compensation Disguised

The accounting rules allow the general partner interest to be disguised in the normal statements of cash flow and net worth. If one digs deeply enough, one can usually find the schedule of trigger points for exploding general partner compensation. It is not in all the financial statements and is understandably glossed over as an "incentive". Unlike a convertible security, where dilution is reported as an increased number of units, or shares, potentially outstanding, there is no similar reported dilution for the general partner interest.

Wall Street and the Financial Press Overstate Value and Understate Risk

We have had a chance to become familiar with the pitches made for Kinder Morgan. In that case it seems clear to us that excessive general partner compensation is not only downplayed, it is confusingly represented in common measures of valuation and risk.

McDep Valuation Raises a Red Flag

Here are the steps to our quantitative valuation. First we estimate Ebitda for the Twelve Months Ended March 31, 2003, the common period for comparing energy companies in our current framework. Our estimate is $183 million, essentially the “run rate” for the most recently completed quarter annualized. We aren’t challenging management’s estimate of $270 million for the year 2002. The important consideration is how we use the estimate. The run rate estimate is more consistent with last year’s balance sheet while management’s estimate anticipates a successful sale of new units to finance acquisitions.

Second, we estimate present value by assessing a multiple of 9.0 times Ebitda, the same multiple we are using for most infrastructure stocks. That gives present value of $1650 million. Management gives investors its estimate that five similar transactions like the Texas intrastate pipeline soon to be transferred were priced at about 8 times Ebitda. Kinder Morgan mentions 6 times Ebitda as their average cost for a different mix of transactions. We could put an 8 multiple on EPN’s estimated Ebitda, but then we would also have to use more units and more debt in calculating net value.

Third, we subtract for debt. From EPN’s website we take debt to be $820 million at year-end 2001. Present value minus debt is then $830 million.

Fourth, we allocate present value to limited partner units. Here is where comparisons by others are often misleading. We believe that some of the value must be assigned to the general partner. For that purpose, the current income split is a convenient, reproducible estimate. In our run rate estimate, the general partner gets 44% of the income, the subordinated units owned by EP get 21%, leaving 35% for the public limited partners. As a result the present value allocable to limited partners is $290 million. When divided

by 36 million units, net present value is $8.10 per unit. That means that the current going concern value of the business is only a fraction of current stock price.

Fifth, calculate a McDep Ratio. Market cap is about $1260 million at a unit price of about $35. The relevant share of debt at 35% is about $290 million. Market cap and debt, the numerator of the McDep Ratio, is $1550. Divide that by 35% of total present value of the underlying business of $580 million and we have a McDep Ratio of about 2.70, the highest of any of the 70 energy stocks in our coverage.

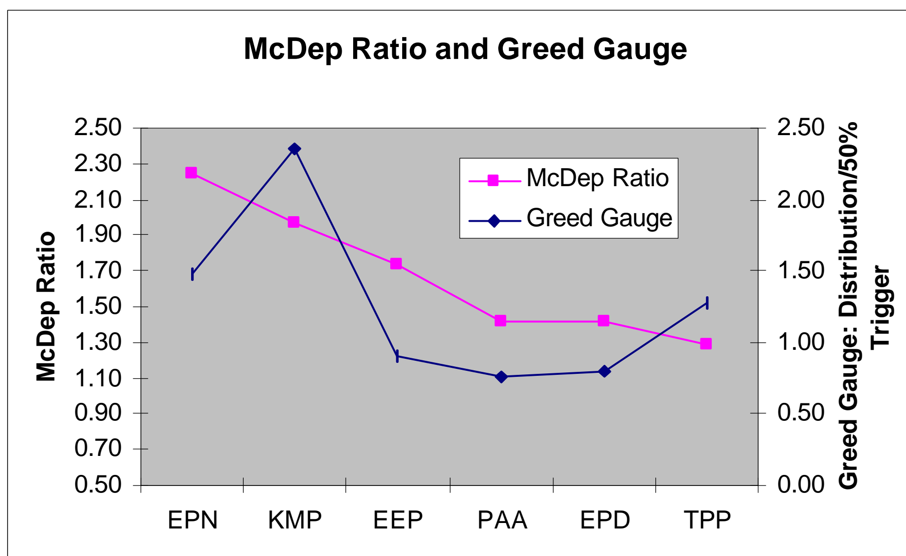
EPN Second Only to Kinder Morgan on the Greed Gauge

We reprint the section below from Meter Reader dated February 18,2002:

"For the stocks with high McDep Ratio and high on the Greed Gauge, the risks seem compounded (see Chart below). The stocks are drawn from the Mid Cap and Small Cap Infrastructure Groups (see Tables M-1, S-1).

When the Greed Gauge exceeds 1.0 the general partner gets half of the incremental cash distributed by the partnership. For Kinder Morgan at a Greed Gauge reading above 2.3 the general partner's share of all cash flow is about 40%.

A high Greed Gauge reading indicates a heavy handicap in cost of capital. New investments must exceed a high hurdle in order to earn the cost of capital (see Chart). Considering the high level of competition in the energy infrastructure industry and the moderate historical returns, we are skeptical that there are few, if any, large-scale industry investments that will return enough to justify a high Greed Gauge reading. Investors who buy high greed gauge stocks are taking on an unnecessary handicap in giving the general partner half of incremental cash distributed."



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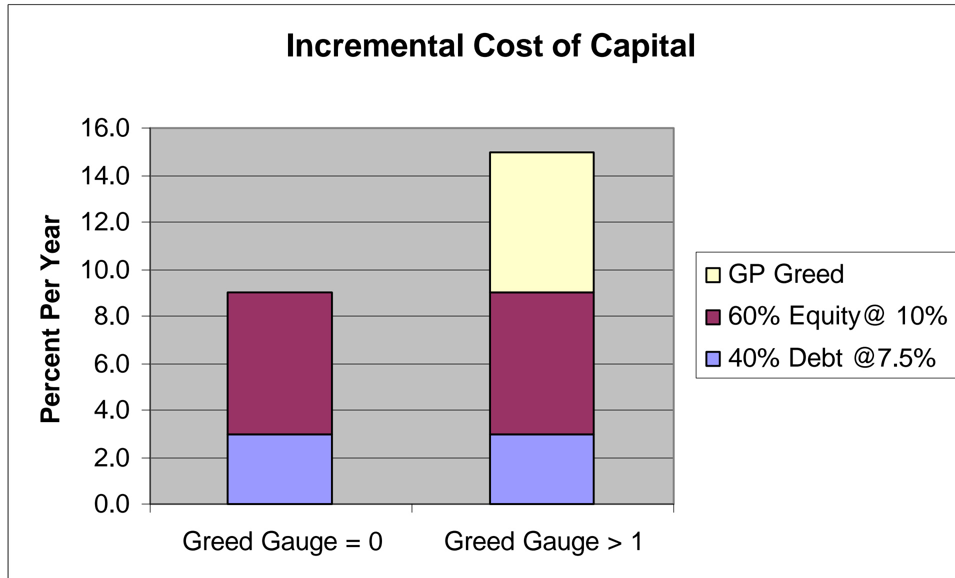

The Offshore Pipeline Business is Interesting

As harsh as our criticism of the structure of limited partnerships and their marketing may be, we are fascinated by the underlying business. EPN is building pipelines to serve the growing oil production from the deep Gulf of Mexico. Some of those projects may be unusually profitable for a while and others may prove to be surprisingly short lived.

Yet EPN is more than its more glamorous business. The Texas intrastate pipeline business is much more mature and can be quite competitive. Even though EPN expects to generate most of its income from fixed fees, the partnership apparently has exposure to natural gas liquids prices that can be quite unpredictable.

We would prefer to invest in interesting businesses where the accounting is straightforward and presented fairly. Nor are we opposed to greed and fees within reason. As long as energy infrastructure companies and their investment bankers act like they are trying to get away with something, we will recommend that investors seeking an honest return look elsewhere.

Kurt H. Wulff. CFA

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El Paso Energy Partners, L.P.
Next Twelve Months Financial Results

	Q3 9/30/01	*Q4E 12/31/01*	***Year 2001E***	***Year 2002E***	***Next Twelve Months 3/31/03***
Revenue ($mm)	43	59	**202**	**236**	**236**
Expense	12	13	**58**	**53**	**53**
Ebitda	31	46	**144**	**183**	**183**
Deprec., Deplet., & Amort.	8	14	**39**	**56**	**56**
Other Non Cash				**-**	
Ebit	23	32	**105**	**127**	**127**
Interest	10	13	**43**	**52**	**52**
General Partner	6	8	**25**	**33**	**33**
Subordinated Units	5	4	**17**	**16**	**16**
Net Income ($mm)	3	6	**20**	**26**	**26**
Shares (millions)	34	36	**34**	**36**	**36**
Per Share ($)	0.09	0.18	**0.58**	**0.72**	**0.72**
Ebitda Margin	73%	78%	**71%**	**78%**	**78%**
Share of Income					
General Partner	43%	44%	**40%**	**44%**	**44%**
Subordinated Units	34%	21%	**28%**	**21%**	**21%**
Limited Partners	23%	35%	**32%**	**35%**	**35%**

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