McDep Associates
Independent Stock Idea
August 19, 2003

Rating: Sell
S&P 500: 1000

Kinder Morgan (KMI-53.49, KMP-40.31, KMR-37.80)
Pipeline Disaster in Arizona

Summary and Recommendation

The magnified market reaction in the form of gasoline lines as a result of a failure in a 48 year-old pipeline adds importance to our sell recommendation of Kinder Morgan (KMI, KMP, KMR). Because the Kinder Morgan securities have high valuation risk and high financial risk, their ability to withstand bad news may be limited. The supply incident is under investigation by the U.S. Office of Pipeline Safety, the Arizona Public Service Commission and the Governor of Arizona. Someone may link the extraordinary cash withdrawals the general partner, KMI, has taken from the owner of the failed pipeline, KMP, with the compromising of public convenience and necessity that pipelines are supposed to serve. The current bad news exposes the moral hazard in the investment thesis of pipeline partnerships that cash flow is for the taking by the general partner.

Gas Lines on the Evening News

Gasoline supply is tight around the world. When supplies are tight disruptions can have surprising impact. Accidents will happen. Sometimes accidents are unavoidable and other times negligence is a cause. A Kinder Morgan pipeline in Tucson, Arizona ruptured on July 30 apparently spewing up to 10,000 gallons of gasoline on five houses under construction. Since then the Arizona crisis has made the national news although there was no mention of Kinder Morgan in the NBC clip we saw on August 18.

Kinder Morgan Response Inadequate

A Kinder Morgan spokesperson has been quoted repeatedly in the *Arizona Daily Star* declaring there was no gas supply problem in Tucson. A Kinder Morgan media advisory on August 14 suggested there would be only minimal impact on KMP revenues and earnings. Now the *Arizona Republic* reports that Governor Janet Napolitano cut short a trip to return to the state on August 18 to deal with the crisis. Apparently Kinder Morgan had also assured the governor that supply would be adequate. As the state chief executive asks all to conserve she emphasizes that now is not the time to play the blame game, but she promises to investigate in depth after the crisis is over.

Warning Signs

The Tucson newspaper, the *Arizona Daily Star* reports that the Office of Pipeline Safety warned previously that the pipe of the type in the Kinder Morgan line had manufacturing defects that could grow over time. In 2000, the office apparently warned that the Kinder Morgan line from El Paso to Phoenix was corroded and in need of repair.

It appears that no one was watching the store carefully. The Phoenix newspaper, the *Arizona Republic* reports that the regulatory effort has suffered from low budgets.

One party that seems to take plenty of cash is general partner, KMI. Kinder Morgan bleeds more than 40% of pipeline cash flow for general partner compensation. Had only a fraction of that been spent on protecting the public convenience and necessity, the present debacle might never have happened.

Some would have investors believe that pipelines last forever and all the cash flow is for the taking. Common sense tells us that pitch is too good to be true. After 48 years, the Tucson pipeline said "No More." It wasn't supposed to happen.

Pipeline investors may remember an explosion on an El Paso pipeline that killed several members of a family in New Mexico, one state to the east. In some ways that incident was the start of the downfall of **El Paso (EP)**. The lost capacity contributed to an energy shortage in California that precipitated retribution against the company, a loss for stockholders and the turnover of management.

Kurt H. Wulff, CFA