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Master Limited Partnerships Take a Hit

Before, MLPs Were Just a Great Way for Midstream Companies to Monetize Yet Still Control Assets, and for Investors to Share in the Cash Flow. Now, It's More Complicated. As GPR has often related, MLPs are good for companies and investors as well. They both get to have their cake and eat it too.

The Companies sell their assets to investors for a market price in return for a promise to pay out the cash flow after maintenance expenses, but they retain control. And, as the company, now known as the general partner (GP) raises the payout to the investors, now known as the limited partners (LP), the GP gets to back in for a progressively higher share of the income. So they take their investment out up front and still get to share in the income from the asset they've just sold. Not bad. At first, they just get to take 2% off the top. But when there's enough in the till to raise the distribution to a second level, they get to typically take 15% of any incremental cash paid out beyond that level. When, bearing that burden, there's still enough in the cash register to raise the distribution to the next level, the companies get to carve out 25% of the income that comes in after that. The final stage is a 50% take, after which the LPs and the GP each take 50 cents of each new dollar that comes in.

Not surprisingly, the gas midstream firms that GPR covers have rushed to put their big fixed investments in gathering and transmission lines, processing plants, storage domes and fractionators into this popular new structure. The beat goes on, with Dynegy announcing two weeks ago.

The Investors. They get a tax-deferred stream of income that grows fast up front, when it has the most present value, and then grows slower as the GP backs in for his increasingly bigger share. Plus, that's a stream that looks good in any financial environment. If business is bad, interest rates are low and any yield investment looks good. If interest rates are high, a yield investment looks bad but the underlying business is good and the distribution, which is like a bond coupon that grows, does that faster than inflation. So what's the problem?

Descriptions of the GPs' Incentive Takes Are in the Always Favorable Brokerage Reports, but Only in the Footnotes and Tables in the Back That Nobody Reads. So maybe investors paid no attention. But now they know. In the last week of February it all came to a head with the dissemination of two unusual research reports that, horrors, actually contained "sell" recommendations on the best-known and best-performing MLP, Kinder Morgan Energy Partners, and one more, El Paso Energy Partners. And MLPs cratered across the board, ending the week 10%-30% off their highs last fall.

Contrarian Analyst Kurt Wulff Took the Punch Bowl Away With a Report on His Website About What the General Partner Takes. Wulff is justifiably known as an analyst who works for the customers, not for the brokerage employers. There are no specific numbers on this, but we will bet he made more money for more investors than any analyst in history--at least in the oil business--when he correctly called the Marathon, Getty, Cities Service, Gulf and Phillips takeovers back in the 1980s far enough in advance for individuals to take advantage of a hefty portion of the run-ups. He did that by cultivating sources--he listened to T.Boone Pickens when the Mesa CEO was just an Oklahoma oilpatch eccentric, long before he became the scourge of inefficient major oil companies and was canonized, however briefly, as the Sage of Amarillo. But it was also his analytic technique--Market Cap + Debt divided by Present Value of Assets, the "McDep Ratio"--that guided him to who was vulnerable. Wulff worked for Donaldson Lufkin & Jenrette during the glory years, and is now an independent working from Needham Mass. Website:www\mcdep.com.

Wulff's issue: The 50% Levy the General Partner Takes Off the Top On Incremental Cash After the LP's Distribution Reaches a Certain Point is a Hidden Dilution to the Limited Partners' Return, Ignored or Downplayed in Brokerage Reports. That's bad enough, but what's more insidious and really hard to see are the termites that sets to eating away at the structure of the MLP from the inside, Wulff says. That's the distortion in general partner motives that the lure of that fat cash payout--earned merely by the GP paying 2% of the new acquisitions or for nothing if the incremental income comes from internal "organic" growth--can cause. Wulff points out that this easy money can cause a GP to make acquisitions for their own sake, whether or not they are accretive in the long term to the LP's return, just to 1)increase the LP's distribution to the 50% GP incentive take point as fast as possible 2)To push it beyond that point to increase the amount of new income subject to that upfront GP "tax" 3)Which will kite the unit price so the GP can have a pricey currency with which to make even more acquisitions, and so on.

This makes MLP size an end in itself which benefits the GP handsomely up front even though the LP can face long-term diminishing returns. That's because the LP must pay 100% of the cost of the new toys at a price that's primed to go up. That's because as the unit base gets bloated, with all the dilution, each new acquisition must be progressively bigger to make a difference on a per unit basis. At a certain point, such assets become hard to find and the seller can see the buyer coming, raising the price he must pay, especially in today's competitive situation, with more MLPs in the hunt. Now add to that insult the injury of losing 50% of the cash flow off the top to the GP and Wulff sees how there can be deals that to the LP are "priced for perfection" and can go downhill if down the road some optimistic assumptions don't work out.

Contrary to What Mae West Said, "Too Much of a Good Thing *is Not* Absolutely Wonderful." To the contrary, as another maverick analyst, John Olson who toils for Saunders Morris Harris in Houston, once observed, growing enterprises with shrinking unit margins bring "profitless prosperity."

What Kind of General Partner Would Be Tempted to Create Such An Enterprise? The Contribution of M. Carol Coale. Ms Coale, who works for Prudential Financial in Houston, is another maverick analyst in the Kurt Wulff vein. She is the only analyst who originally recommended Enron who had the courage and insight to pull the plug before it disappeared. She later criticized herself as having "waited too long" before dumping it at $26, but it is certainly true that that left ample room for a short who could have covered in the pennies and done quite well.

Ms. Coale pointed out in a February 28 report that a small-sized GP created expressly for the purpose of receiving the promoted income from the MLP it sponsors could be motivated to produce growth for growth's sake. "Master limited partnerships have ben in existence for decades but the use of an MLP to fuel the growth of its general partner is a relatively new concept. The idea was pioneered by Rich Kinder in 1997...."

The Point of Wulff's and Coale's reports was to Put "Sells" on Kinder Morgan Energy Partners (KMP). This partnership and its general partner, Kinder Morgan Inc (KMI) suffer on all three points the analysts raised:1) Size, 2)a general partner well into the 50% income sharing level, and 3)a small general partner for whom that promoted cash flow is a vital component of today's income and tomorrow's growth. Ms Coale's Feb 28 report was the catalyst for a "Black Thursday" crash in which KMP fell 15%, on a staggering 6.5 million units traded, to cap a 28% decline from its high last November, later recovered to 18% off. All the other gas midstream MLPs were dragged down that week as well; at presstime they were all 10-20% off their highs. As usual, the market took everybody to the woodshed, making no distinctions, except that KMP was hit the hardest.

Which is What GPR Wants to Correct. What About Midstream Asset MLPs that Pass Wulff's or Coale's Test, or Both? Suppose a GP was only at the 15% or 25% income sharing level? Suppose the GP was a large corporation for whom whatever level it had attained was the least important thing it had to worry about? Or

suppose both situations obtained? Such a GP would have little or no incentive or temptation to pursue size for size's sake, to inflate the assets, or number of units in the capitalization, their attached distribution or their price. Following is GPR's *Table of MLP Temptation* to show how the existing MLPs that are home to midstream assets like gathering lines, processing plants, transmission lines storage domes and fractionators are positioned.

The MLP Table of Temptation

Note: Listed first is the MLP's name followed by its general partner. the first number is the multiple by which distributable cash flow (after maintenance capex) covers the distribution. 1.0x is bare coverage. A small surplus of 1.1x or less shows the GP is pushing the distribution hard, leaving little cushion. The final percentage is the current yield to the limited partners. Degree of shading indicates degree of temptation to drive the MLP too fast.

	General Partner Share>50%	*General Partner Share <50%*
Small GP Sees the Most Impact	*Kinder Morgan Energy Partners/Kinder Morgan Inc 1.04x 7.2%*	*Enterprise Products Partners/ EPCO Inc 1.36x 5%* *Plains All American Pipeline Partners/PlainsResources 1.1x 8%*
Large GP Sees the Least Impact	*Teppco Pipeline Partners/Duke Energy Field Services 1.17x 7.5%* *El Paso Energy Partners/El Paso Corp 1.04x 6.7%*	*Enbridge Energy Partners/ Enbridge Inc 0.94x 8.4%* *Northern Border Pipeline Partners/ Enron Corp & Williams Cos 1.23x 8.1%* *TC Pipelines Partners/Trans Canada Pipeline Ltd 1.2x 7.4%* *Williams Energy Partners/ Williams Cos 1.02x 6.4%*

Quadrant 1 The Fast Lane. *Both Temptations are Present: 1)The GP is past the inflection point for 50% of incremental cash flow and 2) is small enough to care about it. That means getting even more is very important to its bottom line. Kinder Morgan Inc. is a pygmy among its corporate general partner peers who also run MLPs. Its market cap is a mere $4.6 billion while Duke, El Paso and Williams are $28-$12 billion Its only reason for being besides to receive cash from Kinder Morgan Energy Partners is to run the NGPL pipeline, the last remaining asset from 1999's KN Energy acquisition. Everything else has been sold to KMP or to the outside. So to grow the amount of KMP cash flow subject to the 50% duty, which amounts to 46% of KMI cash flow today and is the only source of future growth, must be a very important focus of corporate strategy. The only entity to whom that is more important is Rich Kinder himself, who principally by virtue of his 21% ownership of KMI shares has amassed a personal fortune reputed to be $1.5 billion. (KMI also owns 19% of KMP's limited partner units, but since it paid for those like any other investor we are not concerned with that here except that it is a vote of confidence in the LPs' future. Kinder also reportedly owns a large number of units.) Meanwhile, the flip side of the GP's small size is the huge size of the MLP itself: 165 mm units x $32 = $5.28 billion market cap, easily the biggest one out there even at its currently reduced price, needing a very big acquisition to move all that bulk. As a result, no other MLP has a big a chunk of its cash flow subject to the 50% bite that all goes into KMIs pockets: $209 million out of $557 million in 2001.*

Quadrant 2 The New Yorkers *"We're at the top bracket in our MLP income. So What? We have more important things to think about." The general partners of these MLPs are also at the bonus level where they get 50% off the top. But here it's no big deal. To be sure, that levy is certainly a nice thing to have, but it's not a major part of their income because these GPs are huge corporations. So there's little temptation to grow the partnership with more acquisitions just to increase the portion of the cash flow that's subject to that take. In fact, these are some of the smallest MLPs, under $1.4 billion in market cap.*

Teppco Pipeline Partners (TPP)/Duke Energy Field Services. *Even if we don't regard the monster $28 billion Duke Energy Corp as the GP, and instead drop down to the midstream subsidiary, Duke Energy Field Services which does the general partner work, we still have a huge entity in which Teppco's puny contribution is going to get easily lost. (DEFS is familiar to GPR readers as the largest producer of U.S. NGLs at 420,000 b/d; GPR July 2 2001) Teppco's promoted cash incentive at 50% was worth all of $32 million in 2001 to DEFS; meanwhile DEFS cash flow was $813 million--just a little bit more. Meanwhile DEFS gets only 24% of Teppco's*

total distribution at all incentive levels, small compared to the 40% Kinder Morgan takes out of Kinder Morgan Partners. Teppco's distribution was $1.80/unit when it reached the inflection point beyond which DEFS snared 50% of incremental cash way back in March 2000. DEFS hasn't pushed the payout hard past that point--in two years it's only gotten to $2.30. So as we would expect the GP doesn't seem to be trying to max out the amount of cash that's subject to its 50% levy.

Teppco runs the largest propane/batched product pipeline in the country, from the Gulf Coast to the Northeast; also y-grade NGL lines from East Texas to the Gulf, crude lines from the Gulf to the MidContinent and gas gathering lines in Western Wyoming's Jonah field. (See GPR Feb 12 2001)

El Paso Energy Partners (EPN)/El Paso Corp *This MLP just raised its distribution to $2.60, which is 10c beyond the inflection point for the 50% sharing ratio for incremental cash paid beyond that point. Overall, the GP today nets a modest 33% of the cash off the top. In 2002, the LP should receive $$108million and the GP $56 million. However, that's deceptive. There are preferred MLP units that El Paso Corp also owns which now are not drawing any of the distributed cash. When they do, the sharing will tilt well toward El Paso Corp:48% to the GP, 18% to the preferred, and only 34% to the common units. That's how net income is allocated now according to a recent Raymond James report. However, the preferred is not getting a free ride: It is paying its share of a major asset program including the new Cameron Highway oil pipeline, 50% of the HIOS and East Breaks wet gas line, San Juan Chaco NGL plant, Texas intrastate Valero gas line, the latter three bought from the corporation. (See GPR Sept 10&24 2001) When this stuff starts throwing off cash, the GP will be in position to scoop up about 66% of it, including the preferred. That's actually much more than Kinder Morgan Inc. is getting, which will only be 40% of its MLP's cash in 2002.The optimistic outlook says all the new iron, concentrated on a still-small asset and unit base will still put plenty of cash into the common units' ultimate 34% share. The asset roster and cash output is still modest vs. KMP. This year EPN will pay out $164 million total, last year KMP paid $557 million (See below) But EPN is trying to catch up.All of the new assets will be subject to the 50% GP take for incremental cash. And the GP is already running EPN hard with only 1.04x cash flow coverage of the payout. This is one huge corporation that has turned its MLP into a major profit center The low ultimate cash allocation to the LPs' units earned a sell recommendation from Wulff..*

Quadrant 3-The Stoics *Here there are small general partners that would benefit greatly from being in the 50% incentive bracket, but they are not yet there. Will they push or bide their time?*

Enterprise Products Partners (EPD)/Enterprise Products Co *The GP started out with a big interest in the Mt Belvieu fractionator and some associated pipelines and storage and proceeded to build a vertically integrated empire, with the help of a jv with Shell. That added Gulf Coast processing plant. Then EPD added offshore wet gas input pipelines and onshore dry gas takeaway lines. Fees from the pipes and fractionator offset the volatility of the keep whole contracted plants. EPD is the second-biggest MLP, after KMP, but the GP is still only in the 25% sharing bracket because it has not pushed the distribution, preferring to keep plenty of cash in reserve. At 1.36x, it has the highest coverage ratio.Investors don't seem to mind. They have pushed the unit price up, creating the lowest yield here.The impact on the tiny general partner of a higher payout and getting to the 50% incentive bracket would be huge: the Dan Duncan family owns 70%, which is 2.5x the 21% Rich Kinder owns of KMI. But the GP is resisting the temptation. Shell has the rest of the GP.*

Quadrant 4--The Puritan Four in the Slow Lane *There's just no temptation here to provide the incentive for the general partners to run their MLPs hard.. These GPs easily pass both Wulff's and Coale's tests The GPs are big corporations with wide interests and incomes, they are at the measly 15%-25% brackets for their take of incremental income with the exalted 50% bracket is nowhere in sight, so as you would expect they preside over some of the smaller MLPs, under $1.6 billion in market cap. They don't have the incentive to push the acquisition button hard. In one case cited here there is a core asset with major organic growth ahead that has been supplemented by modest acquisitions as a sideshow. In the other, the core asset is a full cash cow, but a few average-sized purchases were all that were needed to provide a satisfying growth kicker*

Enbridge Energy Partners (EEP)/Enbridge Corp. *That this MLP has a cash flow coverage of distribution of less than 1.0 is misleading. It doesn't mean the GP has been pushing the envelope on the distribution, actually it means just the opposite. For three years, from 1999 through 2001, there were no increases. The coverage is down because the incoming cash flow didn't live up to expectations. That's because the core asset, the U.S. portion of the Enbridge oil pipeline from the Athabasca oilsands to Minneapolis, Chicago, Toledo, Detroit, St Louis, Sarnia and Buffalo, was slow in coming on. In addition conventional Alberta heavy crude production*

unexpectedly slacked off. The Canadian independents just weren't drilling. The long term prognosis for the oilsands is just as good as ever. By 2010 there are supposed to be an extra 1.2 million b/d over and above the 650 million b/d there are today. The competition won't be carrying much if any of that: The Express and TransMountain lines don't have the markets. So if Enbridge gets most all of the new stuff, that would be almost a doubling of the 1.3 million b/d it carries today. Meanwhile, the GP hired MidCoast Petroleum's Dan Tutcher to make some modest U.S. Gulf Coast gathering/processing/NGL investments ($260 million worth so far) to give the distribution a little pizzaz while the limited partners are waiting. (See GPR Nov 19 and December 3 2001)

Northern Border Pipeline Partners (NBP)/Enron Corp & Williams Cos*. The major asset here is the same-named pipeline from Empress to Chicago. That's full, but growth will come from some unregulated Wyoming gathering investments in the Powder River and Wind River Basins, (See GPR Sept 11 2000) plus a medium-sized takeaway line from Chicago to the U.S .Southeast. At 1.23x cash flow coverage, there's already room for a fair-sized distribution hike without even breaking a sweat. In fact, whatever acquisitions NBP has made have been accomplished by its own staff in Omaha without the GPs even noticing, much less pushing the envelope. Enron has been in its own asset-light world for years, whereas NBP is very asset-heavy and has never been of interest. (See GPR Feb 11 2002, the last of the four-part Enron series)*

If the Past is Prologue, Kinder Morgan Partners Would Say, Then What's To Worry? Indeed, what KMP has done for its early 1997 investors is nothing short of incredible. With all distributions reinvested, the partnership calculates, those unitholders would have realized better than a 50% compound annual return. At the same time, the Salomon Smith Barney MLP Composite showed "only" a 19% return. Both sharply outshone the S&P 500, which did a measly 19% over the same period. Did Wal-Mart or Microsoft make any more money for their early investors than Kinder Morgan Partners did? We doubt it.

So far, it would seem that the dreaded 50% general partner take off the top of what the limited partners get has proven to be a burden easily borne by the partnership's mighty cash flow steam engine. That high take kicked in for all income beyond what was needed to generate a 95c/unit distribution for the limiteds. Nonetheless, the partnership engine blew past that point seemingly without noticing, and on only the LPs' 50% cash flow share still pushed the LPs' distribution up 130% to the current $2.30/unit.

The naysayers, however, say that the partnership stressed itself mightily to haul all that baggage all that way, and is suffering internal damage that will render it unable to continue to outperform that way. In effect, they say that the past is *not* going to be prologue, that diminishing returns are setting in:

- The sheer size the partnership has attained makes it difficult to make any acquisition big enough to make a difference to the LP units over which the income will be spread. The dilution of new cash flow will be huge.The unit base is now 165 million, which has doubled since 1999, adjusting for a split. At $39 last November, KMP's market cap was $6.45 billion, 50% larger than the next largest MLP, Enterprise Product Partners. (Since KMP has been hit harder that the others in the recent decline, at $31 its relative size is not as great but it's still clearly the center of mass in the group by a long way.)
- To make an acquisition of that size at a low enough cash flow multiple to also be profitable to the LPs is hard enough. But when they also have to give up 50% of the income off the top to the GP, is a daunting proposition. Especially when increased competition for eligible midstream assets is about to get hotter, because there are so many MLPs out there looking. This will inevitably drive purchase prices *up, not down*. Prudential's Coale says KMP will be at a disadvantage to other partnerships which have large general partners with many assets that they will prefer to sell to their in-house MLPs to keep them in the family and still under the GP's control. KMP, with a general partner set up out of nowhere just to serve that role, does not have that in-house source of assets to fatten its MLP's balance sheet at reasonable prices.
- Internal Stress is already starting to become evident. KMP is pushing the envelope, distributing as much cash as it can to the LPs. With the recent distribution increase to $2.30/unit, total distributable cash flow is only 1.04x the payout--There is no reserve.
- Coale also points out the real cash income component of the cash flow is slipping, while the portion due to depreciation, just an accounting device, is rising. According to KMP's own calculations, depreciation was 24% of distributable cash flow in 1999, in 2001 it was 28%

- The 18% decline in the unit price, from $39 to $32, has raised the cost of capital to make an acquisition, further raising the bar to making a successful one. If units are going to be used as the currency to make a purchase, the buyer can't issue units with a yield higher than what the acquisition will make. The lower the yield on the units the buyer has to issue, the better--that means there will be more daylight between what he's giving up vs what he's taking in. At a distribution of $2.20 and a unit price of $39 last November, KMP units were yielding a miniscule 5.6% to he marketplace.. Now at a distribution of $2.30 and a unit price of $32, they're yielding much more to the LPs--7.2%. When to that is added about 4.3% the GP is paying to itself with his take off the top, that creates a unit burdened by an 11.5% cost of capital. With that costly a currency, the GP can't afford to pay the standard 8x cash flow for a new asset because that returns only 12% of its cost annually. There's no margin there--that's just breakeven.
- Investors could be getting skeptical about KMP's deals. In the past, a major purchase plus a distribution increase would send the unit price way up, reloading the cannon by lowering KMP's cost of capital since its units were now a more potent currency for further acquisition. In 2000 the major $1.5 billion GATX terminal purchase made unit prices soar 36% in the following two months. But in the last week of February 2002 the $750 million purchase of Tejas Pipeline, plus a 10c distribution increase perversely caused just the opposite: an immediate 15% *decline* in the price of KMP units (all but 3% since recovered). One issue could be a perceived declining quality in the purchases. The last two big ones were MidCon Texas in 2001 (which KMI dumped into the partnership after the GP had shopped it around and failed to find an outside buyer) and Tejas last month (See GPR July 2 2001). Both of these are unregulated Texas *intra*state transmission lines that lack the security blanket of demand charges paid by shippers regardless of the volume they use. KMP built its empire by creating a first-class network of regulated *inter*state pipelines with demand charges, for liquid product.. GPR thinks this is a bum rap, however, since as we wrote it seems both lines are working out. MidCon Texas has revived along with its major online processing plant, Houston Central. And now KMP owns two of the three pipelines that supply Houston. The third, Houston Pipeline, isn't going to spoil things by discounting since it's now owned by AEP, a firm in trouble that has to charge premium prices.

KMP Puts Its Investors on a Treadmill Due to the Size of the Unit Base and the 50% GP Take, Making Them Run Faster to Stay in the Same Place. The more KMP makes acquisitions by issuing new units, the more it raises the base of units over which any new income is spread, thus diluting the impact on any one unit. The paradox: The more you grow, the harder it is to grow more. And that's just the beginning. If the GP takes 50% off the top, it's twice as hard to get something meaningful to filter down to each LP unit.

Investors Have the Whip Hand to Put KMP On a Treadmill Of Their Own: Inflating The Cost of KMP's Capital. That creates a daisy chain of consequences out in the financial markets that can make it harder for the GP to make any acquisition. Since an MLP pays out all, or most, of its cash flow, they only way it can get the capital to buy a new asset and grow is by getting outside financing. And the LP unitholders, if they are unhappy, have a stranglehold over that. That's because the inevitable response of the LP unitholders, faced with income per unit that may not rise as fast as before, will be to remove the growth premium from the price of the units, driving them down. That will drive the yield up to a point where they are comfortable. That will debase the currency the GP uses to make acquisitions, just as a currency is devalued. More units will have to be issued (ie, more money will have to be printed) to exchange for a given asset. That, in turn creates even more units over which the income from that new asset will have to be spread.

It gets worse. If there is less growth in distributed income/unit, growth investors will tend to desert the units, to be replaced by value investors who are content with a given tax-deferred yield, and don't need the sex appeal of a growing distribution. These types are perfectly happy with a bond-type coupon that stays the same, but has the advantage of being tax-deferred. But, these are also stingy types who need a higher yield to stay around. So they will not pay up for the units, which would tend to keep them on a permanently lower level than where the go-go growth types would have bid them up to before, in more optimistic days. If the value types become more prevalent in KLMP's investor base, that will put a permanent lid on purchases because the GP's cost of capital will go up. A unit that carries an obligation to pay out 7.2% to whatever outside investor holds it, like KMP units

today, is a lot more expensive currency to use to make an acquisition than is one that only promises to pay out 5.5%, like KMP units two months ago.

It is possible that this process of tectonic shift in the investor foundation may have begun at Kinder Morgan Partners in recent weeks. Rich Kinder may be finding out that when you drive the MLP car at 200 mph, it may lose a few financial wheels in the process.

There are answers to this, but they all involve slowing down Instead of using internal organic growth from existing assets to hype the distribution and heat up the unit price, KMP could turn around and use it for acquisition instead. KMP's existing assets have a lot of organic growth to come, but of course it's not a bottomless cookie jar like issuing new shares is. Or, KMP could use increase the mix of debt to reduce its cost of capital If the new units issued at 11.4% were only 60% of the total and debt at a pretax 6% was 40%, that would create a combined mix of 9.24%. With a currency costing that the MLP could buy an asset at the standard 8x cash flow, which would pay back 12% of its cost every year. There's enough daylight there for a margin of safety. That would work. But you have to be careful issuing debt. KMP has a nice 44% debt/cap ratio, so there's room here. But that cookie jar has a bottom too.

Does Rich Kinder Want to Slow Down? Ulysses had himself tied to the mast as his ship went past the the Sirens so he would not be lured to his death on the rocks. Will RK use a stout enough rope to avoid these sirens? Perfectly good reasons why investors should have been nervous. Alas, there is reason to believe he may continue to play dangerously. He may have put some slip knots in the rope he tied himself to the mast with.

Kinder Morgan Partners' General Partner, Kinder Morgan Inc. Has Already Double and Triple Dipped Into the Pot of the 50% Bonus Distribution. So Why Wouldn't It Go for More? Already a large portion of the total KMP cash flow is subject to the 50% rake-off for the general partner. A larger amount, in fact, than at any other MLP. The GP (KMI) crossed over into the 50% sharing ratio when the limited partners' distribution went past 95c/unit. Considering that the LPs are now getting $2.30, that was a huge distance of dollar amount ago. (When the LPs' distribution was going up to $60c/unit, KMI had to settle for a mere 2% of total cash flow. Between $60c and 71c, KMI was netting 15%, between 71c and 95c, the GP's take rose to 25%. Anything paid beyond that point, $1.35/unit more to be exact, so far, was and is subject to the top GP tax rate of 50%. KMI will continue to get a nickel out of each incremental dime the partnership generates beyond that point.)

Kinder Morgan GP's Rising Levy is Like the IRS Progressive Income Tax. The dollar amount produced for KMI by those rising "tax" rates is rising geometrically because the top 50% rate is applied against the biggest pot of KMP's income. The system works just like the federal income tax. Just like the IRS, KMI has a progressive tax rate: The more the income, the higher the bite. Of today's $102 million cash flow subject to 2%, the GP takes in a mere $2 million while the LP keeps $100 million; for the $21.4 million subject to a 15% levy the GP takes $3.2 million while the LP keeps $18.2; for the $48 million subject to a25% take the GP takes $12 million while the LP keeps $36 million, while at the top rate of 50% both GP and LP split a huge pot of $284 million--each gets $192 million. (Calculations by Goldman Sachs) **The other MLPs may do this some day**, but they can't now because nobody else has raised distributions so fast and furiously for so long a time that they have such a huge pot of money subject to the highest 50% rate.

There is one place where brokerage reports do describe--front and center--the general partner's growing cash take. . That's in reports on KMI, which is the only stand-alone GP that does little else that is publicly-traded. (Kaneb Pipeline LP's GP is the same, but that gets little analyst coverage.) The GP's incentive takes are golden eggs that are a vital annuity to the Kinder Morgan Inc. general partner. They are its entire investment appeal. That's why analysts who cover KMI with the usual glowing reports say KMI will continue to squeeze the goose that lays those eggs. A typical plug for KMI is an August 2 2001 Goldman Sachs report: Under the headline *KMP Receives a Disproportionate Share of KMP's Growth* was the following: "KMI contributes only 2% of the equity consideration for KMP acquisitions and received a disproportionate 38% (and

growing) of the total cash flow and 50% of the cash flow accretion. Acquisitions at KMP have incredible economics for KMI, with IRR's (internal rates of return) over 1,000% and payback periods of less than one year."

Tucked in at the end of that paragraph was the modest warning for KMP investors: *"KMP must continue to find and complete acquisitions that work financially even after making these incentive payments." (italics ours)* Goldman's report diplomatically failed to mention that the very good reasons it cites for investors to buy KMP's general partner may at the same time be reasons why they should not buy KMP itself

If the Point of Diminishing Returns Has Been Reached, A Few Corners Might Have to be Cut to Make the Portion of KMP Cash Flow that's Subject to the GP's 50% Tax Even Bigger. Even if some acquisitions were made returned less than the cost of capital, the LP distribution could still go up for a time due to organic growth of pre-existing assets. Either way, the GP seems bent on continuing to increase the LP's distribution, as before, even as the GP's take goes up even faster. KMP's payout has just gone up by 10c/year, from $2.20 to $2.30, and KMI has promised a $2.50 exit rate for 2002. Alas, there is no built-in discipline on the GP It will not matter to the GP where the incremental income is coming from or how sustainable it is. The GP invests virtually nothing for the underlying assets and then gets 50% of the new cash flow before the LPs' yield is calculated.

It Could Have To Do With the Side That KMI's Bread is Buttered On. And That of Its CEO and Principal Shareholder--Rich Kinder. Investors may want KMP to lower the fire under the acquisition campaign because of a worry that it could be producing more smoke than heat and light. But there is little chance of this happening because the GP benefits so handsomely to the extent it continues, creating proportionally even more cash flow subject to the 50% take for only a 2% investment on its part. Which income will soon be more than 50% of KMI's own cash flow. And one-fifth of all that will flow directly into Rich Kinder's own pocket since he owns 21% of KMI's stock.