Rating: Sell
S&P 500: 1095

Kinder Morgan Management, LLC
Fallen Star

Symbol	KMR	*Ebitda Next Twelve Months ending 9/30/05 (US$mm)*	210
Rating	Sell	*North American Natural Gas/Ebitda (%)*	0
Price (US$/sh)	41.61	*Natural Gas and Oil Production/Ebitda (%)*	18
Pricing Date	10/25/04	*Adjusted Reserves/Production NTM*	12.0
Shares (mm)	54	*EV/Ebitda*	14.6
Market Capitalization (US$mm)	2,250	*PV/Ebitda*	7.9
Debt (US$mm)	870	*Undeveloped Reserves (%)*	50
Enterprise Value (EV) (US$mm)	3,130	*Natural Gas and Oil Ebitda (US$/boe)*	19.43
Present Value (PV) (US$mm)	1,690	*Present Value Proven Reserves(US$/boe)*	8.57
Net Present Value (US$/share)	15	*Present Value Proven Reserves(US$/mcfe)*	1.43
Debt/Present Value	0.52	*Earnings Next Twelve Months (US$/sh)*	2.25
McDep Ratio - EV/PV	1.85	*Price/Earnings Next Twelve Months*	18
Dividend Yield (%/year)	7.0	*Indicated Annual Dividend (US$/sh)*	2.92

Note: Estimated cash flow and earnings at recent quarter rate annualized.
Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

Summary and Recommendation

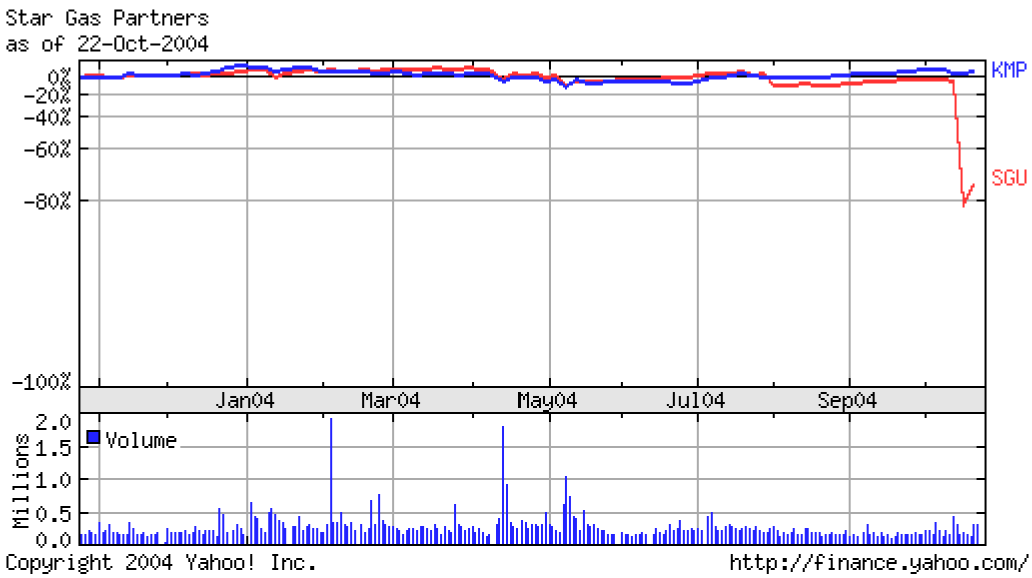
The 80% collapse in stock price for Star Gas Partners LP (SGU) last week attests to the unrecognized risks we see in sell-recommended **Kinder Morgan Energy Partners (KMP)**, **Kinder Morgan Management LLC (KMR)** and **Kinder Morgan Inc. (KMI)**. A highly-leveraged, downstream energy partnership with potentially explosive general partner compensation, Star imploded despite having the active participation of a well-known director, Mr. Thomas Edelman. Only a few months ago the partnership that bills itself as the nation's largest retail distributor of home heating oil enjoyed Wall Street and investor support in an underwriting of new common units. Adding to the risks exposed by Star, Kinder Morgan, in our opinion, understates debt, overstates earnings and compensates the general partner excessively without fully disclosing the negative impact. By our analysis, KMR stock has the potential to lose 64% of value to reach $15 a unit estimated present value of equity in the next few years.

Stock Price and Income Nightmare

SGU stock traded in a stable pattern and then dropped 80% instantly (see chart). For comparison purposes we note that that the stock price pattern leading up to the collapse was nearly indistinguishable from KMP, for example.

The drop in unit price coincides with the suspension of the distribution. One week income investors thought they were getting a $2.30 per unit annual distribution, the next week their income vaporized.

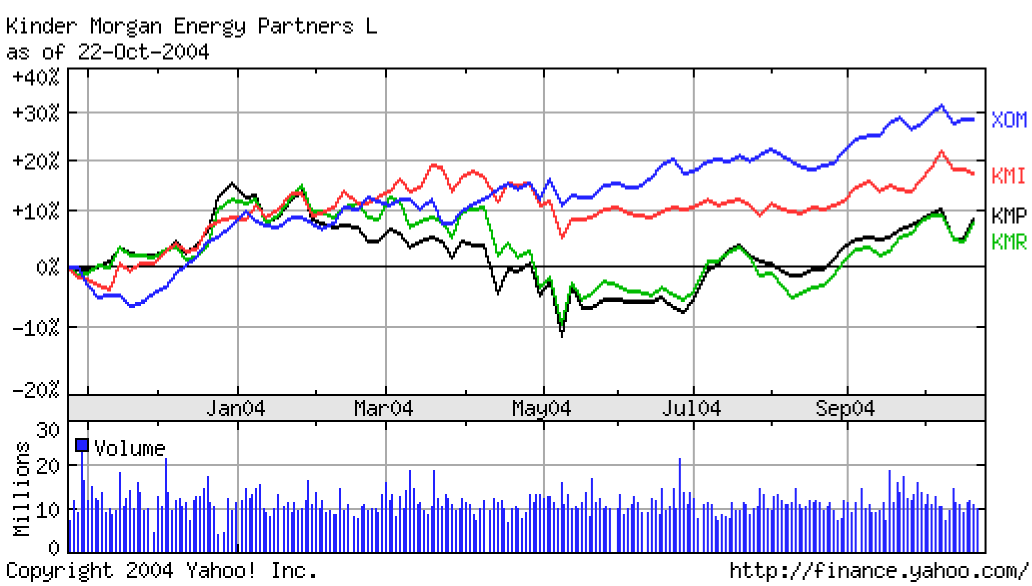
Management attributes Star's difficulties to the inability to pass on heating oil price increases and to customer attrition. In one of its gambits to convince investors of the stability of its cash flow, management used weather insurance. Unfortunately, Star could not weather all contingencies. Moreover, being a highly leveraged partnership that used debt to finance distributions, Star had no long underwear. The Star example illustrates a type of risk that may not show up right away, but is catastrophic when it occurs. Investors need to recognize such vulnerability and avoid it, in our opinion.



Kinder Morgan Underperforms

Though Kinder Morgan stock has not collapsed in the past year, it has underperformed the energy industry. We compare the three KMx stocks with the largest, lowest risk energy stock, **ExxonMobil (XOM)** (see chart).

The difference widens when one adjusts for financial risk. For example, XOM has a ratio of debt to present value of 0.08; KMI 0.74. Equal positions in unlevered present value would have the amount invested in XOM stock 3.5 times the amount invested in KMI stock (1-0.08)/(1-0.74). Alternatively, one could say that the unlevered return in XOM was 27% (29% times (1-.08)) compared to KMI at only 5% (18% times (1-.74)).



High Valuation, High Financial Risk and High Business Risk

We like the energy business, but we believe it is unwise for investors to pay a double digit cash flow multiple, EV/Ebitda, for the KMx entities when the largest and best energy stocks in the world are priced at mid-single digit multiples. Moreover, the combined KMx with high debt and questionable accounting have little ability to withstand a change in financial conditions. Finally, we do not believe that paying 42% of average and 50% of incremental distributions to the general partner, who makes essentially no capital contribution, can be a viable, long-term, healthy business.

Commodity Price Helps Incremental Cash Flow

In the low oil and gas price environment of the 1990s, KMx attempted to minimize commodity uncertainty with its emphasis on fixed price business. In the extreme case more recently, KMx bought half the Yates oil field in West Texas, an asset jewel, and apparently sold the oil forward for years at about $25 a barrel, half the current price. Investors were encouraged to pay a high multiple for KMx cash flow because it was growing steadily independent of commodity price.

Now it is ironic that KMx get some current positive news from commodity price. We have added a commodity section to our quarterly model that illustrates potential revenue gains from oil price advances. It appears that the natural gas liquids portion of KMx's oil production is unhedged. If so and if actual oil prices follow futures, it would add some $6 million to next quarter's revenue, $4 million to quarterly cash flow and match about half the $9 million increase in quarterly distribution (see table Next Twelve Months Financial Results).

Partnership Continues to Hide Debt

It was amusing to read that KMI has "reduced" its debt in the past quarter. We see an increase in ratio of debt to present value for KMP from 0.49 to 0.52. Our ratio of debt to present value for KMI rises from 0.73 to 0.74 in the latest quarter. We believe that KMI misleads investors when it does not report KMP debt on the KMI balance sheet.

Compensation Milestone

With the latest increase in distribution, the general partner's average share rises to 42% from 41% rounded. That is the highest we know of in the energy industry.

We question whether investors get fair presentation of general partner compensation. We believe the general partner fees are equivalent to an equity interest that should be disclosed as a reduction of limited partner equity on the balance sheet of KMP. In fact, KMI calls its proceeds from KMP "equity earnings". We further believe that KMI overstates its earnings from KMP when it reports an amount two-thirds of what KMP reports and it claims that is does not own enough KMP to require consolidated reporting.

Kinder Morgan Energy Partners, L.P.
Next Twelve Months Financial Results

	Q1 3/31/04	*Q2 6/30/04*	*Q3 9/30/04*	*Q4E 12/31/04*	***Year 2004E***	*Q1E 3/31/05*	*Q2E 6/30/05*	*Q3E 9/30/05*	***Next Twelve Months 9/30/05***
Oil Volume									
Oil (mmb)			3.6	3.6		3.5	3.6	3.6	**14**
Oil (mbd)			39	39		39	39	39	**14**
Oil Price ($/bbl)									
WTI Cushing			43.89	54.14		53.55	51.42	49.40	**52.13**
Partnership			26.48	28.03		27.95	27.67	27.40	**27.76**
Oil Revenue ($mm)			95	101		98	99	99	**396**
Ebitda									
Products Pipelines	114	119	120	120	**473**	120	120	120	**480**
Natural Gas Pipelines	103	95	105	105	**408**	105	95	105	**410**
CO2 Pipelines	78	76	86	90	**330**	88	88	88	**355**
Terminals	63	66	67	67	**263**	67	67	67	**268**
Overhead	(51)	(43)	(40)	(40)	**(174)**	(40)	(40)	(40)	**(160)**
Total Ebitda	307	313	338	342	**1,300**	340	330	340	**1,353**
Deprec., Deplet., & Amort.	68	70	74	74	**286**	74	74	74	**296**
Ebit	239	243	264	268	**1,014**	266	256	266	**1,057**
Interest	47	47	48	48	**190**	48	48	48	**192**
Ebt	192	196	216	220	**824**	218	208	218	**865**
General Partner	92	96	100	103	**391**	104	104	105	**416**
Net Income ($mm)	100	100	116	117	**433**	114	104	114	**448**
Units (mm)	193	196	197	198	**196**	199	200	201	**199**
Net Income Per Unit ($/un)	0.52	0.51	0.59	0.59	**2.21**	0.58	0.52	0.57	**2.25**
Distribution Per L.P. Unit	0.68	0.69	0.71	0.73	**2.81**	0.73	0.73	0.73	**2.92**
Distribution ($mm)	222	230	239	248	**938**	249	250	251	**998**
General Partner	91	95	99	103	**388**	104	104	105	**416**
Limited Partner	131	135	140	144	**550**	145	146	146	**582**
General Partner Share									
Earnings	48%	49%	46%	47%	**47%**	48%	50%	48%	**48%**
Distribution	41%	41%	41%	42%	**41%**	42%	42%	42%	**42%**

Star Gas Reminds Investors of the High Risk of Partnerships with Misplaced Incentives

Star Gas reminds us of the low financial quality of partnerships with exploding compensation agreements. The misplaced incentives seem to drive the partnerships to unsound practices such as using debt to finance distributions. Along the way, there appears to be inadequate communication of financial risks and results.

Kurt H. Wulff, CFA

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