J.P. Morgan Securities Inc.
Equity Research
Anatol Feygin (1-212) 622-6448
anatol.feygin@jpmorgan.com

JPMorgan

Industry Analysis

Energy MLPs

A Conservative Vehicle for Growth

Natural Gas & Pipeline
Equity Research
Anatol Feygin
(1-212) 622-6448
Gabe Moreen
(1-212) 622-6547
Gil Gabbay
(1-212) 622-6459

We see positive prospects for many master limited partnerships (MLPs) in our sector and believe they offer attractive investment potential in today's uncertain markets. In the past 52 weeks, on average, energy MLPs offered investors a total return of 25.8%, relative to the 2.8% total return of the S&P 500 over the same period. These publicly traded partnerships have compiled impressive stock market track records in the past couple of years, and we believe this performance will continue, as many provide clear visibility for growing their distributable cash. This report focuses on natural resources MLPs that contain midstream energy assets. Ownership of MLPs is restricted to individual investors.

See also our report on El Paso Energy Partners, which is being published concurrently.

Many MLPs offer investors not only tax-advantaged yields but capital appreciation potential as well. Through their special tax-advantaged structure, MLPs can usually tax shield 80-90% of their cash distribution (dividend) payouts. Successful MLPs protect investors against interest rate risk by consistently increasing their cash distribution levels. A typical growth MLP enjoys a strong relationship with its general partner (GP), which manages the publicly traded partnership for its benefit and that of the MLP's unit holders (shareholders). A growth MLP usually has a strong GP with a large stable of assets that the GP is willing to divest into the MLP structure in a transaction that benefits both the LP unit holders and the GP.

As quasi fixed-income instruments with large dividend yields, MLP's yields trade in tandem with prevailing interest rates. We found a high level of correlation between MLP yields as a group and five-year treasury yields. In establishing a price target for El Paso Energy Partners LP (EPN), we believe it appropriate to forecast the MLP's distributable cash flow and assign a spread to the five-year treasury at which we estimate EPN should trade (based on its historical spreads and its particular profile). The higher an MLP's projected growth rate, the higher its price/yield multiple, and the more favorable its spreads relative to Treasuries.

The future for midstream energy MLPs looks bright. Within the next several years, we expect assets worth billions of dollars to be optimized through their placement into MLPs. We believe there is no fundamental reason that MLPs should not own all qualifying midstream energy assets.

An investment in an MLP has tax implications beyond those of investing in a common stock. We recommend that investors consult with a competent tax advisor regarding these implications prior to making an investment in an MLP.

Anatol Feygin (1-212) 622-6448
anatol.feygin@jpmorgan.com

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Master Limited Partnerships are publicly traded partnerships that generally contain energy-related assets. The partnership is between the holders of publicly traded Limited Partnership interests (LP units) and a General Partner (GP) that manages the MLP on both its and the LP unit holder's behalf. For inclusion within MLPs, assets usually exhibit stable cash flow characteristics. As with REITs, MLPs are not taxed at the corporate level and generally pay out a large portion of the cash they generate in the form of cash distributions.[1] Please see our discussion below "A Brief—And Important—Overview of MLPs" for a more detailed description of the MLP structure.

Positives

Positive Prospects in the Face of Uncertain Markets
We believe that many MLPs in our sector offer attractive investment potential in today's uncertain markets. These publicly traded partnerships have compiled impressive stock market track records in the past couple of years, and we believe this performance will continue, as many provide clear visibility for growing their cash distributions.

MLPs that can consistently increase their distributions are called "growth MLPs."

Tax-Advantaged Yields Plus Capital Appreciation Potential
Many MLPs offer individual investors not only tax-advantaged yields but capital appreciation potential as well. Through their special tax-advantaged structure, MLPs can usually tax shield 80-90% of their cash distribution (dividend) payouts to investors. This results in significantly higher after-tax yields for individual investors than comparable fixed-income investments do. Moreover, MLPs can also raise their distribution payouts through a prudent growth strategy, offering the potential of higher MLP unit (stock) prices.

Fundamentally Conservative Investments with an Attractive Risk/Reward Equation
We believe MLPs' distributions are more secure than dividend payments for conventional corporations, and the consistent cash flow generated by an MLP's underlying assets rewards investors with consistent distribution payouts. Although MLPs are subject to some principal risk or capital decline owing to their fixed-income-like structure, investors have slowly come to realize that MLPs with credible growth strategies do not deserve to trade solely as interest-rate-sensitive investments. MLPs also occasionally stumble in operating their assets, but we believe many have properly mitigated these operational risks.

Consistent Growth in Cash Distributions Makes MLPs Distinctly Different from Bonds
Growth MLPs have compiled records for consistently increasing their cash distributions over time, making them distinctly different from bonds. The growth of their cash distributions has come from acquisitions and from efficient operation of their underlying assets. By consistently increasing their distributions, these MLPs take on equity-like characteristics, which in turn allow them to trade more as stocks than bonds. They can also protect investors against interest rate risk, since they consistently increase the "coupon" paid on their security.

Certain MLPs Are Characterized by Strong Relationships with Their General Partners
Successful growth MLPs enjoy strong relationships with highly regarded general partners (GPs), which manage publicly traded partnerships for their benefit and that of the LP unit (share) holders. More important, the typical growth MLP has a strong GP with a large stable of assets that the GP is willing to divest into the MLP structure in a transaction that benefits both LP unit holders and the GP. The GP's assets serve as the basis for future MLP distribution growth, as newly acquired assets throw off additional cash that can be used to increase distributions.

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[1] However, unlike REITs, there is no mandatory cash payout level.

Spinning Off Assets into MLP Benefits GP in Several Ways

Spinning off assets into its MLP gives the GP a number of advantages. Foremost are the significant returns that the GP can derive. The MLP fully pays for these assets, usually removing a chunk of debt from the parent GP's assets and thereby deleveraging the parent GP's balance sheet while receiving cash for the midstream asset. The GP also maintains operational control over the asset and can still receive significant cash flows from the asset.

Risks

GP Promote Is a Blessing and a Challenge, As It Disproportionately Rewards the GP

The cash portion of the incentive distribution agreement that goes to the GP is referred to as the "GP promote."

In addition to having confidence in the GP's operating efficiency and management integrity, investors must be aware of the agreement between a GP and an MLP's limited partners. The cash that LP unit holders receive is subject to a legal agreement between the LPs and the GP. This agreement covering distribution of cash between the GP and LPs serves as the basis for aligning incentives between the GP and the LP unit holders. It does, as intended, provide the GP with an ever-increasing percentage of distributable cash flows while maintaining operational control over the asset. However, as the GP increases its share of the MLP's overall distributable cash flow, the cost of capital for MLPs can increase.

The Law of Large Numbers and Success of the GP Present Systematic Hurdles

As an MLP raises its distribution through organic growth, operating efficiencies, and/or acquisitions, it needs more absolute growth to sustain its growth rate. Furthermore, the challenge is exacerbated by limited access to institutional capital (to finance large acquisitions) and the decreasing economics for LP unit holders. Again, we expect that MLPs that have been successful to date—by tapping institutional equity or by spinning down assets from parent to subsidiary—will continue to find ways to overcome these obstacles to growth.

MLPs Have Come Under Investor Scrutiny Since Enron's Collapse

Unlike MLPs, energy marketing and trading operations are governed by FAS 133, where trading positions are marked to market to reflect a position's current profit or loss, even though a position is still outstanding.

Since the collapse of Enron, MLPs as a class of securities have come under increased scrutiny due to general concerns over corporate accounting, as well as MLPs' exposures to "related-party transactions" when the GP spins down assets into its MLP. While we think investors should be vigilant in their sensitivity to these accounting issues, the accounting surrounding MLPs is fundamentally different from that of merchant energy companies. MLPs own with real assets that generate supporting cash payouts on a quarterly basis. Their accounting is straightforward, and their earnings are realized in cash and do not involve the "mark-to-market" accounting issues that have concerned investors in the merchant energy space. Finally, related-party asset transfers between the GP and its MLP will only work in the long term if they benefit both the GP and LP unit holders, thus effectively protecting the interests of LP unit holders, in our view.

The Perennial Concern: Interest Rate Risk

JPMorgan economists believe that interest rates have already bottomed, with a 4.72% current rate on the five-year Treasury but a 5.3% rate expected at year-end.

Interest rate risk is a perennial concern, given the fixed-income component of the MLP investment and valuations supported by relative spreads to medium-term treasury yields. Rising interest rates also usually increase borrowing costs for MLPs. A period of rising inflation may also hurt MLPs, as many of their contracts are fixed-fee in nature and thus do not vary with a change in overall price levels. However, the bulk of MLP operating costs are fixed in nature, not variable, and thus are less susceptible to an uptick in inflation. Although we have little doubt that interest rates have bottomed for the present, we see limited drag on the performance of units where distribution growth is apparent. The track records of successful players should continue to drive down spreads at which these issues trade, and distribution growth should more than offset pressure on the instruments' "face value."

A Brief—And Important—Overview of MLPs

Some Features of a Partnership, But Publicly Traded

A cursory glance at MLPs might lead investors to conclude that they are extremely complex, as they are governed by a different set of regulations than conventional "C" corporations. The first step in demystifying MLPs is to understand that they are publicly traded partnerships and have been around since 1980. MLPs exhibit many of the tax-advantaged characteristics found in privately held partnerships, but they also offer the positive features of publicly traded companies: LP unit holders can trade their units in public markets, all MLPs are subject to SEC oversight and disclosure rules, and MLPs generally provide regular quarterly cash distributions (dividends).

Basics of the Partnership Agreement

The general partner and limited partner unit holders enter into an agreement. In exchange for providing capital to the partnership, limited partners, which are owners of the publicly traded partnership units, receive cash distributions and share in any appreciation in the value of the partnership. Unit holders give the GP leeway in operating the partnership as the GP sees fit, and they give the GP financial incentives to manage the MLP effectively.

Every GP has a financial interest in the MLP. This interest normally begins with a 1-2% interest in the partnership's net income. However, this interest is generally only a starting point for compensation. Alone, it is insufficient to motivate the GP to either expand the partnership or operate it with greater efficiency.

To more properly align the incentives of the GP and the LP unit holders, there is generally an incentive distribution agreement between the GP and unit holders. The agreement allows the GP to capture a greater share of the MLP's incremental cash flow as the MLP increases cash distributions. When an MLP increases quarterly distributions past agreed-upon benchmarks, the GP receives a higher percentage of incremental cash flows. Past a certain distribution level, the GP reaches what is known as the "high splits," where it maximizes its share of incremental cash flow, usually at 50%. As distributions increase, LP unit holders receive a smaller share of the total cash distribution pie. However, the increase in the size of the overall pie compensates for the LP unit holders' diminished share on a percentage basis.

Table 1 demonstrates a sample distribution agreement between a GP and LP unit holders, in this instance between Kinder Morgan Energy Partners unit holders and its GP, Kinder Morgan. As the table illustrates, the GP receives a larger share of incremental cash distributions as distribution levels increase.

Table 1: Kinder Morgan Incentive Agreement for Sharing Cash Distributions

Annual Distribution per Limited Partner Unit		% of Incremental Cash Flow		Cash Distribution Level @ $3.97 per LP Unit	
		General Partner	Limited Partner	General Partner	Limited Partner
From: $0.000	To: $0.605	2%	98%	$0.01	$0.61
0.605	0.715	15	85	0.02	0.11
0.715	0.935	25	75	0.07	0.22
0.935	3.970	50	50	1.46	1.46
				1.57	2.40

Source: Company reports.

Anatol Feygin (1-212) 622-6448
anatol.feygin@jpmorgan.com

Just What Assets Are in MLPs?

MLPs are asset intensive and usually own low-growth cash-generating assets, typically in industries characterized by extensive government regulation. Although some MLPs contain real estate, professional sports teams, and theme parks, most are natural resource MLPs. More important, natural resource MLPs are the largest and most liquid in the entire MLP universe, as they constitute about 70% of all MLPs' market capitalization. Natural resource MLPs are also disproportionately the most successful, garnering more than 90% of the entire sector's net income.

The U.S. tax code defines MLP qualifying income from natural resources as "income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber)."

There are currently four types of natural resource MLPs, each with a different asset base:

- Pipeline/midstream energy
- Oil and gas exploration and production (E&P)
- Propane distributors
- Forest products

There is some overlap between these types of assets, but most natural resource MLPs tend to focus on a specific asset class. Of the four MLP types, forest products and oil and gas E&P MLPs are considered the highest risk to own, since they are the most exposed to raw commodity prices. Propane MLPs are also involved in seasonal businesses with significant exposure to end-user propane, and are considered less conservative investments than pipeline/midstream energy MLPs. In our judgment, the propane sector does not offer the best risk/reward scenario for investors because of its significant exposure to commodity risk. In addition, propane MLPs also tend not to have strong relationships with their GPs.

We believe the greatest opportunities for growth MLPs lie in pipeline/midstream assets. Here investors can find a relatively unconsolidated asset base, excellent management teams, and MLPs with strong GPs interested in fostering the growth of their MLPs. Most important, assets can be prudently structured to mitigate direct commodity risk exposure, protecting the MLP investor against swings in the commodity cycle and making for stable cash flows to investors. Unlike other types of MLPs, pipeline/midstream assets usually do not take ownership of commodities (with proper operating contracts in place), so they partially obviate commodity risk. In addition, these assets are less cyclical than direct natural resource E&Ps, as they are less affected by the general macroeconomic climate.

A Breakdown of Pipeline/Midstream Energy MLP Qualifying Assets

Pipelines
Pipelines owned by MLPs are common carrier transporters of crude oil, petroleum products, natural gas, or natural gas liquids (usually butane, ethane, gasoline, or propane). Pipelines serve a variety of end users, including commercial businesses, airports, utilities, and retail customers—depending on the size and type of the pipeline. Since they may be in a position to exercise monopoly power, certain pipeline owners are tightly regulated by the Federal Energy Regulatory Commission (FERC), which ensures that different product shippers have an opportunity to gain access to the pipeline space. FERC also regulates the rates that pipelines can charge, attempting to balance the needs of pipeline users receiving competitive shipping rates and letting pipeline companies charge a "just and reasonable" return on their pipeline investments. Although pipelines are a slow growth business, they generate a large amount of cash and require little maintenance capex. Since shippers often sign long-term contracts, cash flows from pipeline assets can be predictable and secure.

Figure 1: A Natural Gas Pipeline

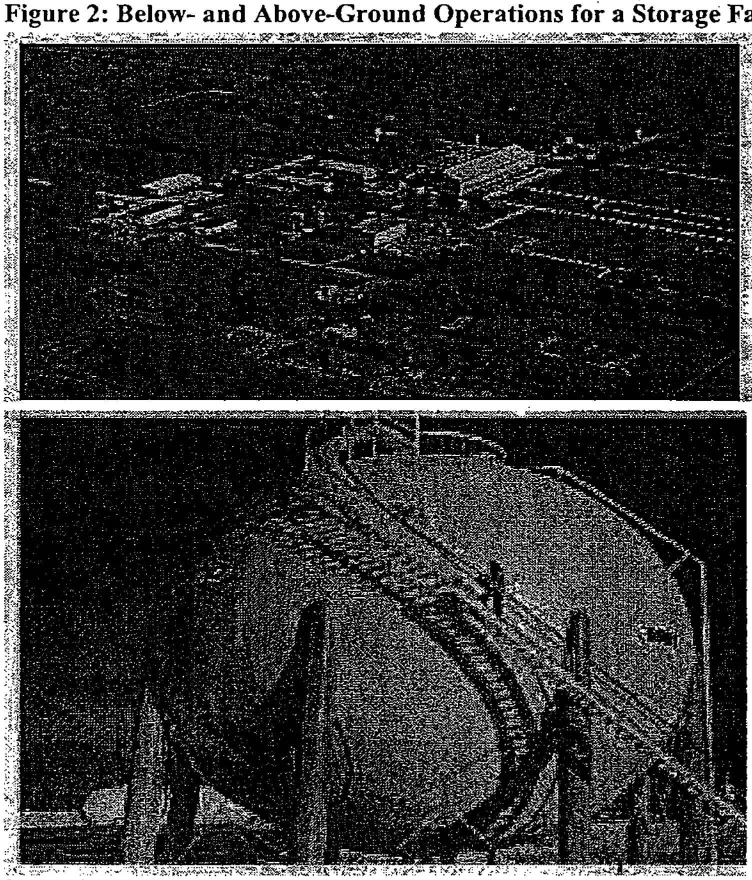
Source: Company reports.

Storage

There are generally two types of natural gas storage contracts: a firm contract guarantees a gas shipper storage space for a certain amount of time, and interruptible contracts are subordinate to firm contracts and do not provide space to shippers if storage is too tight.

These assets store different gas and oil products and are located intermittently along major pipeline thruways. Storage facilities can contain natural gas, natural gas liquids, crude oil, and refined products. MLPs do not assume ownership of the commodities they store, and they are paid for storage on a volumetric basis and according to the type of contract users sign. In the storage business, location (preferably at the intersection of several major pipelines) and capacity are the two most important determinants of success.

Figure 2: Below- and Above-Ground Operations for a Storage Facility



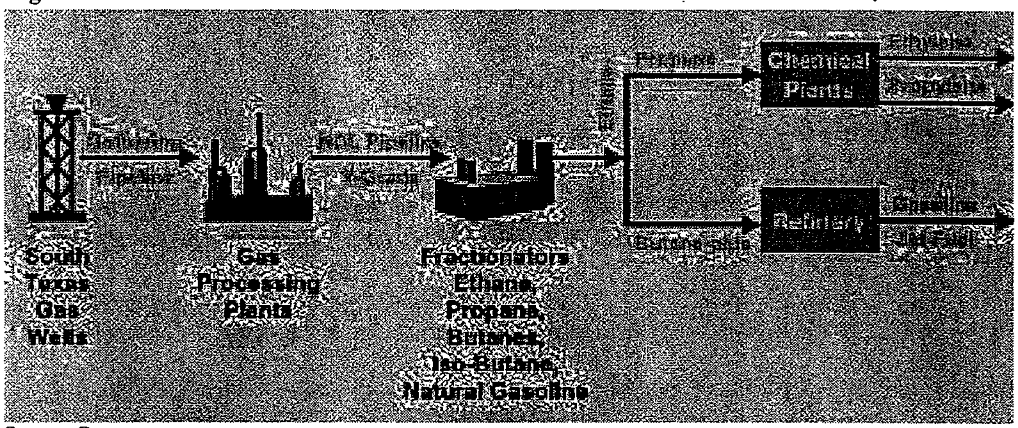
Source: Company reports.

Anatol Feygin (1-212) 622-6448
anatol.feygin@jpmorgan.com

Gathering, Processing, and Fractionation

MLPs often own assets that assist in the gathering of natural gas, oil, and other natural resources discovered from offshore or on-land exploration sites. Extensive interconnections gather gas or oil discoveries and transport them to processing plants and compression facilities. Gathering infrastructure is provided to exploration and production companies that prefer not to own gathering assets, as they are low-growth low-margin businesses. Often connected to gathering systems are fractionation plants that process natural gas liquids (NGLs) into ethane, propane, and butane products. Fractionation facilities are usually located in strategic areas close to NGL end users.

Figure 3: Natural Gas: From Wellhead to Final Product



Source: Company reports.

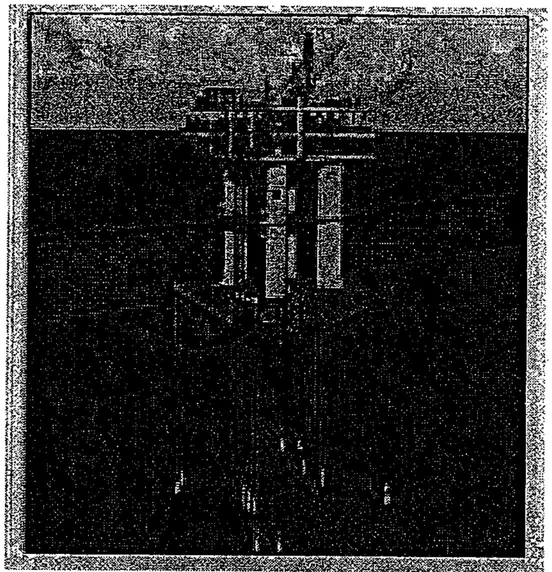
As in pipelines, MLPs usually do not assume ownership of the commodities they handle. This is especially important in processing and fractionation, as the MLP is not at risk for an adverse price shift in either the input commodity or final product. Instead, as in pipelines, MLPs are compensated for processing and fractionation services through tolling agreements, which are essentially volumetric-based fees. An MLP will usually acquire infrastructure to provide these services only if it foresees sufficient demand to make the investment economical. To better anticipate cash flows from such assets, MLPs will lock in services from users in long contracts and will locate assets near geographic areas with extensive proven commodity reserves.

Platforms

Platforms process oil and natural gas production before it is shipped onshore.

Midstream/pipeline MLPs have also branched out into owning deepwater platforms, the offshore equivalent of processing assets. MLPs with platforms are rarely involved in actual exploration and production, preferring to avoid direct commodity exposure and, instead, to provide platform services to E&P players. Although some MLPs do have E&P properties, they have tended to exploit existing production and have not expanded their E&P holdings. We agree with this strategy, as the volatility afforded by direct commodity exposure is inappropriate for a conservative vehicle like an MLP, which should maintain steady cash flows and avoid the capital intensity of the natural resource E&P business.

Figure 4: An Offshore Platform



Source: Company reports.

Asset Diversification Suits Us Fine

We do not consider E&P assets appropriate for an MLP, but we are attracted by MLPs that pursue (along with growth) asset diversification and involvement in many links of the midstream energy value chain. Such diversification allows MLPs to offset weak performance in one asset class with stronger performance elsewhere. To cite a relevant example, in a weak commodity environment, pipeline volumes might be down owing to lower production, but weak pricing can boost demand for gas storage facilities as gas shippers seek to store natural gas until more favorable pricing prevails. A well-balanced portfolio of assets gives an MLP a cushion so that it does not have to cut its cash distributions.

Robust Outlook for Pipeline/Midstream Assets

Recent asset divestiture announcements have come from such large industry players as El Paso, Dynegy, and Williams Companies. The total divestiture program could exceed $2 billion in assets. See our discussion on page 12 that explains companies' motivations for placing assets in MLPs.

Positive Near-Term Outlook Thanks to Asset Divestiture Programs

The preliminary growth and consolidation phase that saw the rise of the "growth midstream MLP" is largely over. However, it is becoming more apparent as time passes that MLPs will become the principal source of capital for the midstream/pipeline sector. This should portend many opportunities for growth in coming years. Many corporations with large midstream MLP-qualifying assets have recently announced that they aim to divest a significant amount of these assets as part of their balance sheet restructuring programs. Although we expected such an event to occur eventually, these divestitures will expedite the trend among corporations to "optimize" their midstream assets.

El Paso Corp. (EP/$44.51/Buy) has already announced a $560 million net asset sale to its El Paso Energy Partners MLP, consisting primarily of the largest intrastate pipeline in Texas, as well as a number of gas processing assets. Dynegy (DYN/$28.96/Long-Term Buy) has announced its intent to sell up to $250 million worth of midstream assets and will form its own MLP to facilitate the transaction. Williams Companies (WMB/$23.41/Market Performer) is likely to sell close to $750 million in midstream assets to its own Williams Energy Partners MLP or by selling them to third-party MLPs (see Table 2).

Anatol Feygin (1-212) 622-6448
anatol.feygin@jpmorgan.com

Table 2: GP Balance Sheet Restructuring Summary

Company	Ticker	Action(s) planned	Completed?
El Paso Corp.	EP	Equity issuance ($850MM)	Yes
		Asset sales ($2.25B)	Partial
		Capex reduction ($1B)	Ongoing
		Debt/capital goal of 50%	Ongoing
		Move debt onto the balance sheet	No
		Eliminate all rating triggers	No
Dynegy	DYN	Equity issuance ($500MM)	Yes
		Asset sales ($150MM) [b]	Ongoing
		Capex reduction ($500MM) [b]	Ongoing
		Debt/capital goal of 45%	No
Williams	WMB	Equity issuance ($1.1B equity-linked convertible securities)	Yes
		Asset sales ($250-750MM)	Ongoing
		Eliminate all rating triggers	Yes
		Debt/capital goal of 54%	Ongoing

Source: Company presentations and JPMorgan estimates.
Note: Aggregate savings from capex reductions and assets sales amount to $750 million.

See our February 15, 2002, industry report, Natural Gas in 2002 and Beyond, *for a discussion of prospects for the natural gas sector.*

A Turn in the Commodity Cycle Should Also Help

MLP capital should abound in an environment that currently supports higher levels of E&P in North America. Although activity has abated somewhat with the recent drop in commodity prices, it should nonetheless stay strong, with a rebound predicted for oil and natural gas prices.

Table 3: Second Half of 2002 Should See Firming Commodity Prices

($/MMBtu gas; $/bbl WTI)

	1Q01	2Q01	3Q01	4Q01	1Q02E	2Q02E	3Q02E	4Q02E	2003E
Natural gas	$6.66	$4.40	$2.81	$2.44	$2.35	$2.25	$2.90	$3.40	$3.50
WTI	28.80	28.00	26.60	20.50	23.80	25.50	26.70	27.00	24.70

Source: JPMorgan estimates.

Although we stress that MLPs usually do not assume direct commodity risk, they are affected by the general commodity pricing environment. Higher commodity prices should mean more throughput on MLP systems and greater demand for platforms and other services for commodity production.

How Does an MLP Grow?

Three Compelling Options

Efficiency Gains and Incremental Capacity Expansions
A GP can increase cash distributions through the more efficient operation of a partnership's assets, such as spending less money on operating expenses. An MLP can also increase capacity on many of its volumetric assets, such as pipelines or processing stations. However, these avenues to growth are limited, as MLPs can squeeze their assets for efficiencies only a finite amount in terms of operating cost and capacity.

Organic Greenfield Growth Projects
More promising is the development of organic growth projects that leverage an MLP's existing asset portfolio. Examples include the construction of a new natural gas storage facility to meet additional demand, the laying of an interconnect between a pipeline and a natural gas user (an electric generator), and the construction of a platform. Most important in constructing such projects is ensuring that a stable revenue stream backs the project, allowing it to be accretive to the MLP undertaking the venture.

Disciplined Acquisitions Drive Sustainable Growth—Third and Most Potent Option
Growth by acquisition tends to trump efficiency gains and organic projects, since they can be immediately accretive and can be larger than organic projects. Because MLPs are tax-sheltered, their lower cost of capital gives them a natural bidding advantage for midstream energy assets over conventional corporations. The best MLPs take a disciplined approach to acquiring midstream energy assets at a purchase price that will be accretive to the partnership. MLPs usually fund acquisitions with a combination of new LP units and debt. The current levels of cash distribution on units (and the GP promote on those units) must be factored into the economics of an asset acquisition. Also, the relative accretion provided by asset acquisitions are dependent on the cost at which MLPs can raise capital.

The matrix shown in Table 4 illustrates the economics of a sample MLP asset acquisition.

Table 4: Sample MLP Acquisition Matrix—The Accretion of a $400 Million Deal
($ in millions, except per unit)

	Purchase EBITDA Multiple			
	5	6	7	8
Annual Cash Flows from asset	80.0	66.7	57.1	50.0
Interest Expense	14.0	14.0	14.0	14.0
Distribution to Existing LP units	16.7	16.7	16.7	16.7
GP Promote on new units	6.2	6.2	6.2	6.2
Excess cash flow to distribute	$43.1	$29.8	$20.3	$13.1
Potential distribution/unit	$0.93	$0.64	$0.44	$0.28
GP Share of potential dist./unit	$0.46	$0.32	$0.22	$0.14

Source: JPMorgan estimates.
Note: Assumptions: $400 million purchase price, 50/50 debt/equity, 7% debt cost; unit price of $30 and $2.50 in annual cash distributions per LP unit. Assumes no maintenance capex for acquired asset and assumes that the GP and LP unit holders split incremental distributable cash 50/50.

With their growth and excellent performance of the past several years, many MLPs have found the public markets increasingly receptive to funding their acquisition strategies and have successfully funded progressively larger acquisitions. For stronger MLPs, gaining access to the capital markets should not be a problem in the future.

Anatol Feygin (1-212) 622-6448
anatol.feygin@jpmorgan.com

Asset sales between a GP and its MLP are vetted by an independent third party, and most MLPs have set up conflicts committees to evaluate such potential acquisitions. Related-party transactions will only work in the long term if they are complementary to both the GP and LP unit holders.

A Strong GP Is Enough—But Not Obligatory—to Fuel Growth

We like MLPs where growth can be generated by having the GP spin off assets into the MLP. Using the same methodology as in the example above, the MLP pays the GP a set price for a specific asset owned by the GP. As in acquiring assets from outside, the MLP is disciplined enough to pay only an amount that increases cash distributions for the firm. MLPs whose GPs have a large amount of midstream assets in the pipeline are particularly attractive, since it makes economic sense for the GPs to spin down such assets into their MLPs.

A GP with an asset dowry (common MLP parlance for assets that the GP has available to sell to its MLP) to divest into its MLP also allows the MLP to avoid having to pursue acquisitions from third parties, where we expect competition for assets to become progressively fiercer, and assets may be sold at valuations that may be pricey for some MLPs. Although certain players have, in fact, thrived without a GP with a significant asset dowry, this path to growth is a bit more difficult. It usually requires scale to attract sufficient capital and a management team experienced in valuing and operating midstream assets.

Table 5: Recent Third-Party MLP Asset Acquisitions

($ in millions)

Date	Acquirer	Seller	Asset	Purchase Price ($MM)	Proj. EBITDA ($MM)	Purchase Price/ EBITDA
Dec.-01	Kinder Morgan Energy Partners	InterGen	Tejas Gas	$750.0	$95.0	7.9
Oct.-01	Enbridge Energy Partners	Williams	South Texas pipelines	50.0	NA	NA
Oct.-01	Enbridge Energy Partners	Koch Midstream	East Texas gathering and processing	230.5	29.0	7.9
Sep.-01	Teppco Partners	Alberta Energy	Jonah Gas Gathering Co.	360.0	45.0	8.0
Jul.-01	Kinder Morgan Energy Partners	Occidental Petroleum	Texas natural gas pipeline	360.0	NA	NA
Jan.-02	Teppco Partners	Valero Energy	Chapparral and Quanah pipelines	130.0	16.0	8.1
Jan.-02	Enterprise Products Partners	Valero Energy	Diamond-Koch NGL storage assets	129.0	NA	NA
1H-2002	El Paso Energy Partners	El Paso Corp.	EPGT Assets	750.0	100.0	7.5

Source: Company reports and JPMorgan calculations. Note: JPMorgan rates Alberta Energy (AOG/$43.93) a Market Performer.

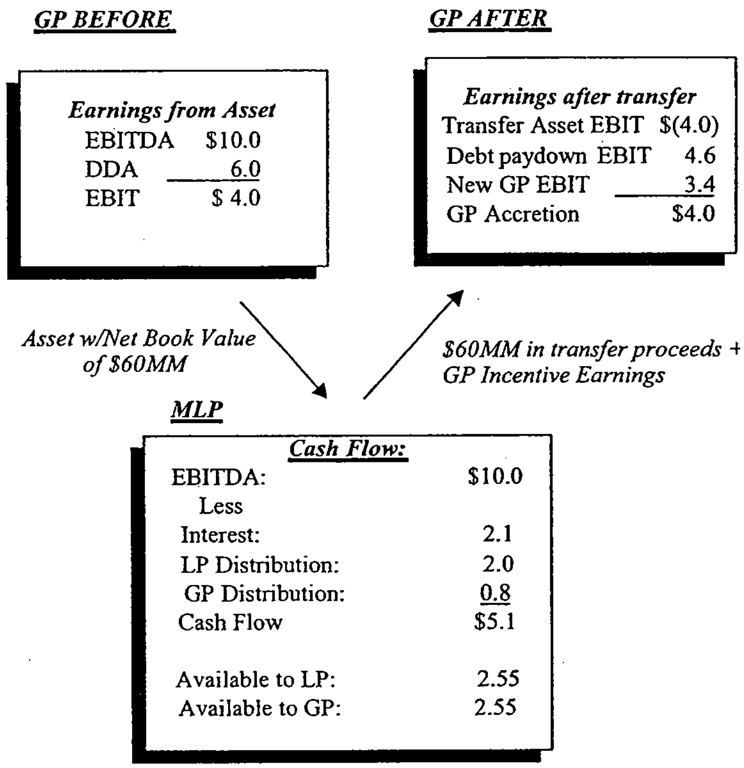
Why Should the GP Care to Place Assets into an MLP? Answer: The Promote

GPs (and, to a slightly lesser degree, midstream companies that do not operate MLPs) have several incentives to place as much of their qualifying assets as possible into their MLPs:

- **It frees up capital from a slow growth area while still controlling the operation of the asset.** The GP can redeploy proceeds from sales of slow-growth assets, like gathering and processing, into higher-growth businesses, and the GP still operates the asset, which is especially important when the asset has imbedded optionality (such as storage) and can be used effectively in the trading and marketing operations of a merchant energy player.
- **It presents the GP with an opportunity to deleverage its balance sheet.** The GP can erase debt through the asset sale to the MLP and can generally strengthen its balance sheet—an issue that has gained prominence lately in the energy sector.
- **The GP can rid itself of large depreciation and depletion charges.** Such charges, which are drags on earnings, can be put to better use in a vehicle with greater tax advantages.
- **The GP generates cash from assets while the assets are accretive to earnings.** The GP receives cash for the asset, as well as cash generated by the asset once in the MLP (through the GP's ownership of LP units and the incentive distribution arrangement). This allows the GP to continue to receive the benefits of the asset (consistent cash flows) while the assets themselves are accretive to earnings.

Figure 5 illustrates the economics driving a prospective asset transfer from El Paso Corp (the GP) into El Paso Energy Partners (the MLP).

Figure 5: MLP Asset Transfer Transaction Delivers Accretion
($ in millions)



Source: Company reports.

When MLPs do issue new units, distributions on those new units are in line with cash distributions to existing units. New unit holders must be paid the existing cash distribution before existing LP unit holders benefit.

LP unit holders have little to fear from embarking upon an acquisition spree that would reduce distributions for LP unit holders. With the incentive distribution, the GP increases its cash proceeds only through a general increase in cash flows thrown off by an MLP. An acquisition or asset spin-down will make sense only when the GP sells the asset to the MLP at an EBITDA multiple that will be distribution-accretive. Although MLPs have the right to issue new units to finance asset growth, this issuance is checked by the need to make an acquisition distribution accretive. Similarly, many MLPs have covenants built into their debt agreements that require them to maintain debt/capital ratios below a specified level. Taken together, these two constraints on financing should ensure that MLPs take a disciplined approach in pursuing asset growth.

See our Appendix I: Sample MLP Profiles, for a complete listing of the various tiers of each MLP's incentive distribution agreements.

MLP Structure and Distribution Arrangements Not as Important

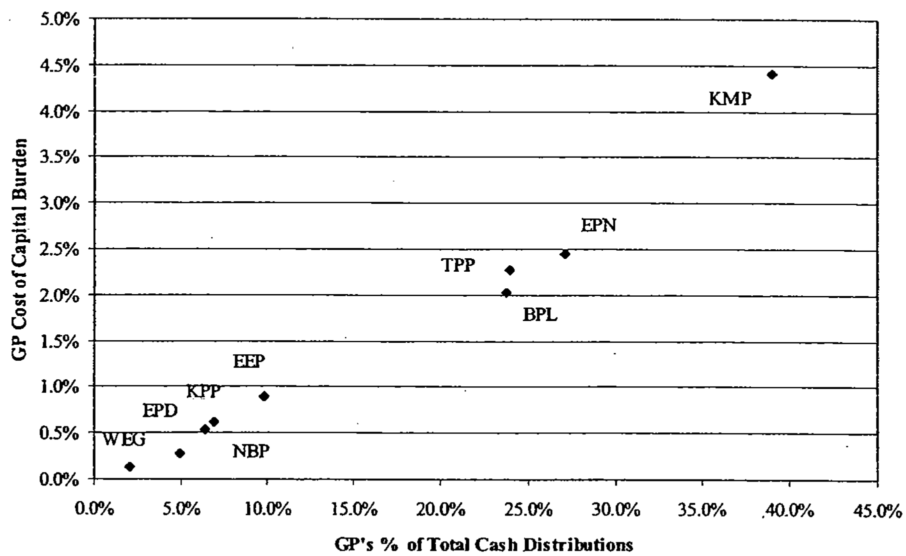
Each MLP has a unique incentive distribution agreement for sharing incremental cash flows. Some agreements set the "high splits"—the level at which the GP maximizes its incremental cash flows at higher levels than do other MLPs—benefiting LP unit holders. However, once at the high splits, most incentive distribution agreements split incremental free cash flow equally between the GP and LP unit holders. Ideally, we think investors should look for MLPs that are at the cusp of reaching the high splits, thereby maximizing marginal incentives to increase the partnership's distributable cash. Although a GP near the high splits and a favorable incentive distribution agreement are important considerations (see page 14 for a discussion of this issue), we think they are secondary to such issues as the diversity of an MLP's assets, a strong GP with a number of assets to spin down, and a capable management team focused on maximizing the partnership's cash flows.

Cost of Capital for MLPs & the GP Incentive Distribution—Why Both Matter

Despite our conviction that the level of an MLP within the incentive distribution agreement is not as important as certain other factors, the percentage of cash that the GP possesses overall does matter relative to an MLP's ability to pay for prospective acquisitions. MLP's tiered incentive distribution agreements are structured so that, as an MLP increases its distributions, the GP collects a larger share of the overall cash distributions. While not hurting existing LP unit holders per se—the GP only is paid cash in line with its agreed share and does not reduce existing distributions to LP unit holders—it does make the issuance of equity capital by an MLP to fund prospective distributions more costly, all other things being equal. This is because the GP will need to pay out the existing distribution levels—both the LP unit distributions and the GP promote on that LP distribution level—on new units issued to fund acquisitions. Those MLPs in the "high splits" that pay out more cash to their GP will need to pay this cash on the issuance of new units.

We have termed this the "GP cost of capital burden" as, *ceteris parabis*, MLPs that in the lower tiers of their GP distribution agreements (i.e., they are paying less of the overall cash pie to their GP) will have a cheaper cost of capital than their counterparts that are higher up in their incentive distribution levels. Figure 6 below shows that as the percentage of overall cash paid to the GP increases (represented on the X-axis), the extra yield that the MLP must pay on new units is higher (represented by the Y-axis).

Figure 6: Various MLP's "GP Cost of Capital Burden"



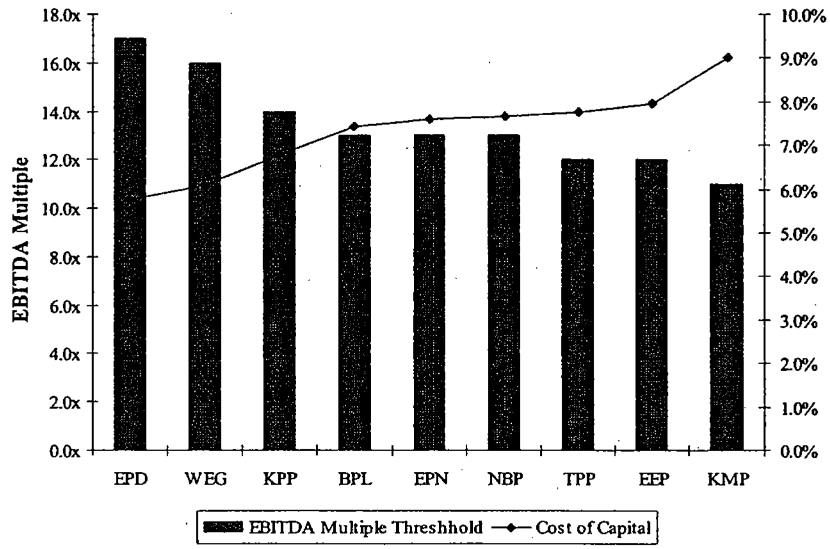
Source: FactSet and JPMorgan calculations.

Cost of Capital Does Limit Multiples on Accretive Asset Acquisitions

Of course, this fact is no reason for MLPs not to pursue a growth strategy. In fact, a higher "GP cost of capital burden" is likely a sign that the MLPs management has executed successfully on its growth strategy and the GP is now enjoying its "just desserts" in the high splits. However, the "GP Cost of Capital Burden" does influence MLPs' cost of capital calculations and the price that they can afford to pay for asset acquisitions (as measured by an EBITDA threshold).

The lower an MLP's cost of capital, the higher EBITDA multiple at which an MLP can afford to acquire an asset while still having the asset be accretive to LP unit holders. The figure below (Figure 7) represents our calculation of various MLPs' cost of capital, given their capital structure at the end of last year. Of course, this cost of capital calculation represents a specific snapshot in time (March 23, 2002, to be exact) and changes over time. Nonetheless, it does demonstrate that certain MLPs have a significant cost of capital advantage when bidding for MLP-qualifying assets. Still, many other factors go into an MLP successfully bidding for assets. These reasons, some of which we already stated, are of great importance and include a strong management team, capacity to finance transactions, and assets provided by its GP.

Figure 7: Cost of Capital & EBITDA Multiple Asset Acquisition Thresholds



Source: Company reports, FactSet, and JPMorgan calculations. Note: Assumes no maintenance capex on acquired assets.

VALUATION

A Strong Relationship to General Interest Rates

As quasi fixed-income instruments with large dividend yields, MLP yields generally trade in tandem with prevailing interest rates. A significant correlation between the movements in general interest rates and MLP yields indicates to us that MLPs should be valued on the basis of their spread to interest rates. Although there is variation among the different MLPs with regard to the strength of their yield's correlation to interest rates, we attribute the variation to company-specific factors, not to an overall break in the relationship between MLPs and general interest rates.

Table 6: Correlation between MLP Yields to Treasury Yields

Name	Two-Year	Five-Year	10-Year
Buckeye Partners LP	0.90	0.88	0.81
El Paso Energy Partners LP	0.88	0.87	0.81
Enbridge Energy Partners LP	0.74	0.74	0.74
Enterprise Products Partners LP	0.94	0.93	0.85
Kaneb Pipeline Partners LP	0.95	0.93	0.88
Kinder Morgan Energy LP	0.81	0.79	0.80
Northern Border Partners LP	0.77	0.77	0.75
TEPPCO Partners LP	0.77	0.75	0.69
Average	**0.85**	**0.84**	**0.79**

Source: FactSet. Note: Correlations are for the two years through 3/24/02.

For the past two years, we have found the highest level of correlation between MLP yields as a group and two-year treasury yields, with the correlation five-year treasuries only marginally behind. In establishing a price target for EPN, we used JPMorgan forecasts for five-year Treasury yields, preferring to value MLPs on a somewhat longer dated interest rate instrument.

Higher Growth Rates Translate into Higher Valuations

An important factor for MLP valuation is that the higher its projected growth rate, the higher its price/yield multiple and the more favorable its spreads relative to treasuries. The four MLP names with the highest growth rates in our sector according to FactSet—Williams Energy Partners, Enterprise Products Partners, Kinder Morgan Energy, and El Paso Energy Partners—all have above-average price/yields and tighter spreads relative to Treasuries. Of the four, the three with long enough track records have seen their spreads relative to Treasuries contract or become steady as they have demonstrated significant growth in the past several years. We think investors have realized that the ability of these growth MLPs to increase their distributions at impressive rates allows investors to risk valuing the MLPs at tighter spreads to Treasuries than their more slowly growing peers. The distribution growth afforded by these growth MLPs gives investors a cushion if interest rates take an adverse turn.

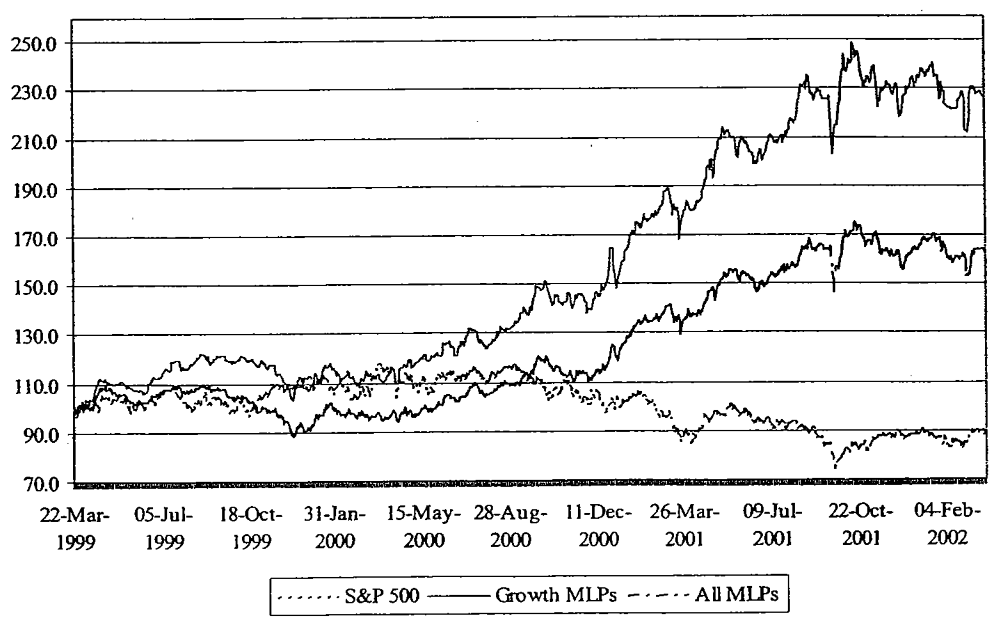
Table 7: MLP Statistical Comparison

($ in millions)

Name	Ticker	3/26/02 Price	LP Unit Equ. Value	LP Firm Value	Yield	Est. L-T Growth	Price/ Yield	P/E 2002E	P/E 2003E
Buckeye Partners LP	BPL	$38.90	$1,047	$1,381	6.4%	5.0%	15.6	14.3x	13.8x
Enbridge Energy Partners LP	EEP	44.06	1,452	2,307	8.2	8.0	12.2	25.2	21.5
EOTT Energy Partners LP	EOT	8.85	243	456	11.3	5.0	8.9	19.7	19.7
Enterprise Products Partners LP	EPD	47.63	4,156	4,886	5.2	10.0	19.1	18.3	17.2
El Paso Energy Partners LP	EPN	36.95	1,468	2,418	6.8	10.0	14.80	52.8	35.5
Kinder Morgan Energy LP	KMP	32.95	5,463	8,256	6.7	14.0	14.4	18.1	16.2
Kaneb Pipeline Partners LP	KPP	39.41	849	1,104	8.0	5.0	12.5	12.1	11.6
Northern Border Partners LP	NBP	39.49	1,643	3,277	8.1	7.5	12.3	15.2	14.4
Plains All American Pipeline LP	PAA	24.50	1,069	1,551	8.4	7.5	12.0	15.3	14.0
TC Pipelines LP	TCLP	25.02	438	453	8.0	6.0	12.5	10.9	10.3
TEPPCO Partners LP	TPP	31.24	1,264	2,329	7.4	8.0	13.6	17.4	16.2
Williams Energy Partners LP	WEG	38.90	442	575	6.1	7.5	16.5	21.6	19.7
Mean					*7.5*	*7.8*	*13.7*	*21.0*	*18.1*

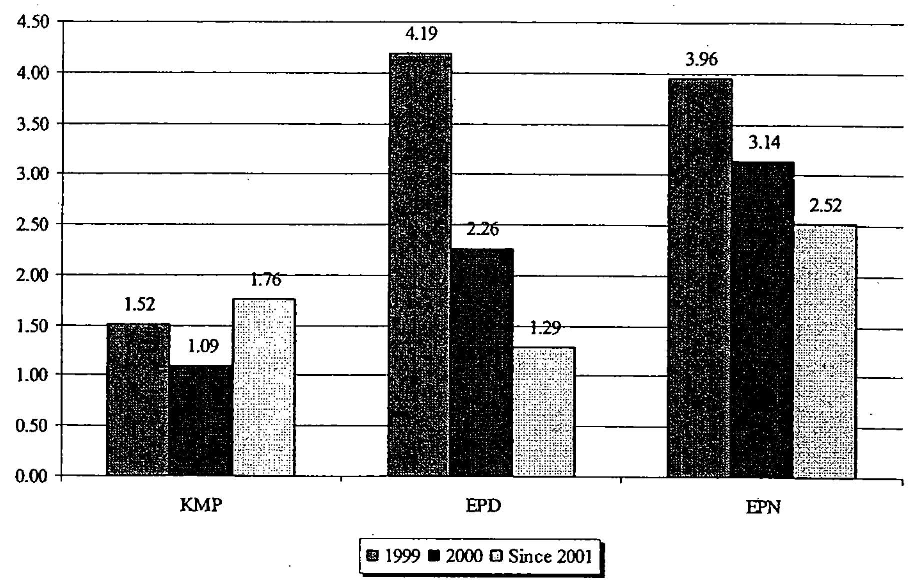
Source: JPMorgan estimates for EPN; all other estimates based on FactSet consensus.

Figure 8: In Tandem with Growth MLP Outperformance . . .



Source: FactSet data through 3/24/02. Note: Growth MLPs are EPD, KMP, and EPN. MLPs are EPD, KMP, EPN, BPL, EEP, NBP, KPP, and TPP.

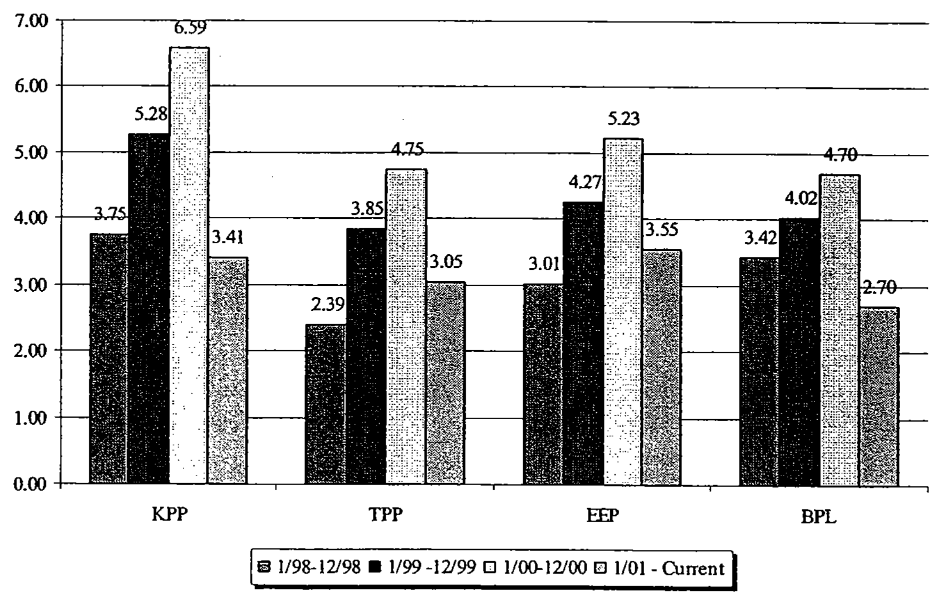
Figure 9: Growth MLP Spreads Relative to Five-Year Treasuries Have Tightened



Source: FactSet.

MLPs with lower consensus growth rates in the past several years have exhibited more stable but higher spreads to five-year Treasuries, probably as investors have realized that their lower growth prospects require protection against interest rate risk and a higher spread to five-year Treasuries.

Figure 10: Slower Growth MLPs Exhibit Higher Spreads to Five-Year Treasuries



Source: FactSet.

Anatol Feygin (1-212) 622-6448
anatol.feygin@jpmorgan.com

MLP Price Target Math

Our process for valuing MLPs is fairly straightforward (summarized below in Table 8):

1. Determine the MLP's future distribution 12 months forward, given underlying business trends for that MLP and resulting distributable cash.[2]
2. Establish the proper future spread between that MLP and the five-year treasury note 12 months forward. Admittedly a subjective determination, this calculation takes into account the MLP's historical spreads, the MLP's prospects for future growth, and investor sentiment toward both the individual MLP and the entire MLP class of securities.
3. Use the JPMorgan interest rate forecast on five-year Treasuries.
4. Establish a price target based on the MLP's prospective dividend, its spread relative to the five-year Treasury, and the yield level of the five-year Treasury bond.

Table 8: Sample MLP Target Price Math

	Current	in 12-mos.	Comments
1. Current MLP price	$20.00		
2. Annual dividend/LP share	$2.00	$2.25	Models indicate annualized distributions will rise to $2.25/LP unit in 12 months
3. Projected spread to 5-yr Treas. note	2.5%	2.0%	Strong and stable growth of the MLP warrants a contraction in its spread to the 5-yr treas.
4. JPMorgan 5-yr Treasury yield	5.7%	6.0%	JP Morgan projects a rise in interest rates in twelve months time
5. Total projected yield	8.2%	8.0%	The projected contraction in the MLPs spread relative to the 5-year treasuries has offset the increase in the 5-year treasury yield
6. Projected price target		$28.13	Divide the projected distribution by the total projected yield to arrive at the 12-month price target

Source: JPMorgan.

LAW, POLITICS, AND I-SHARES: MLP REGULATION

MLP Taxation

It's *Not* True That the Only Things Certain in Life Are Death and Taxes

MLPs, like private partnerships, avoid double taxation.

The partnership structure has significant tax advantages. A conventional "C" corporation is taxed at two levels: income at the corporate level is taxed at the corporation's effective tax rate, and dividends received by shareholders are taxed at the individual shareholder's income tax rate (or, if shares in the corporation are sold, at the appropriate capital gains rate). Unlike corporations, the MLP structure allows for taxation *only* at the individual unit holder level. Income derived from an MLP is treated for tax purposes as flowing directly through to individual LP unit holders without an intervening tax at the corporate level. Individuals are then taxed on their share of the partnership's income at their individual tax rate levels.

Each year, LP unit holders receive a K-1, a special tax form reporting distributions derived from MLPs.

A lack of double taxation is not an MLP's only tax benefit possibility. Not only is net income for the MLP not taxed at the corporate level, but most midstream/pipeline MLPs can effectively tax shield 80-90% of their cash distributions to LP unit holders. Since many of the assets contained in midstream/pipeline MLPs take large annual depreciation charges on their asset bases, net income reported for MLPs tends to be much lower than actual cash generated by MLPs (defined as available cash on which cash distributions are determined).

In annual filings to the IRS, MLP unit holders must pay income tax only on their share of the MLP's net income. In most cases, though, the amount of cash that unit holders receive from the MLP is much greater than their actual share of the MLP's net income. Through the differential between net income and actual cash distributions received, midstream/pipeline MLPs can tax shield significant portions of their cash distributions, with investors paying

[2] Distributable cash flow is generally calculated as EBITDA, minus: maintenance capex-and interest expense. Generally, MLPs like to maintain a cushion of 1.1x distributable cash flow to actual distributions.

income tax only on the MLP's actual income. As a consequence, LP unit holders may not have to pay current income taxes on the vast bulk of the cash distributions they receive.

There are a number of important caveats. Although cash distributions in excess of a unit holder's share of the MLP's net income are not taxable as a combination of ordinary income and capital gains, they do reduce the holder's original cost basis. Thus, some portion of cash distributions received by unit holders is better described as tax-deferred, not tax-exempt. The excess distribution is treated as a return of capital, and the tax deferral embedded in each LP unit is taxed as regular income only when the unit holder decides to sell his or her interest in the MLP. It is important to note that an MLP unit holder's cost basis cannot drop below zero. Any net losses recorded by an MLP in a given year can be used to raise the MLP unit holder's original cost basis, effectively offsetting gains from future years. However, these tax losses can be used only to offset income from the same MLP and cannot offset income from other MLPs.

Tax Deferral Feature Enables Flexibility
The tax-deferred status of much of the MLP cash distribution option has significant advantages, and not just in terms of the time value of money. It allows MLP unit holders to realize deferred taxes embedded in an LP unit at the unit holder's discretion, adding flexibility to an MLP investment. Also, such significant tax implications discourage investors from selling capriciously and help an MLP amass a stable base of unit holders.

MLPs Reward Accountants Too
LP unit holders must disclose their share of the MLP's net income and cash distributions on their federal tax returns. MLP tax items are reported to the IRS and investors on a K-1 form that is distributed by MLPs by March 31 of each year. MLPs' investor relations departments provide detailed earnings information to MLP investors. Unit holders may be subject to reporting their share of an MLP's income to the state in which the MLP operates.

MLP Regulation: These Aren't Your Parents' Partnerships

Partnerships of Yore Were More Speculative
MLPs of today are not those that were popular in the mid-1980s. Before Congress tightened the definition of what could be considered a publicly traded MLP in 1987, MLPs consisted of a diverse set of businesses, including real estate, restaurants, and even professional sports teams. Investors were burned by many of these MLPs, some of which did little more than speculate on the direction of commodity values.

A popular MLP structure at the time was an MLP based solely on underlying real estate. The real estate assets were financed via a zero-coupon bond and cash distributions were drawn from the capital invested by LP unit holders. Thus the expectation was that the underlying real estate asset would rise enough in value to refinance the asset at a higher value, allowing the MLP to increase distributions after it had exhausted investor capital for distribution payouts. Another structure was the rollup MLP devoted to combining a series of private limited partnerships and then offering it to the public, often disguising the true nature of the underlying partnership assets. Many of these MLPs ended badly for investors, and it is not surprising that MLPs continue to carry a stigma from this era. It is important to understand that many of the scandals surrounding partnerships in the 1980s resulted from private partnerships, *not* those of the publicly traded partnership variety.

Threat of De-Corporatization Prompts Congress to Act
Businesses in many diverse industries began to seriously consider "de-corporatizing" to qualify for the tax-favored status afforded MLPs. Around 1985, Congress became warier of the growing number of businesses using the MLP structure as a tax shelter. Prompted both by the looming budget deficits of the mid-1980s and by IRS complaints about the administrative costs of keeping charge of MLP unit holders and their taxes owed, Congress, in the Revenue Act of 1987, relegated the MLP structure to the four types of businesses cited on page 6. It was determined that an entity could not organize as an MLP unless it derived 90% of its gross income from so-

called "qualified sources, primarily real estate or natural resources businesses."[3] Those existing MLPs that did not fit under the guise of either natural resources or real estate were grandfathered under a 10-year exemption that preserved their MLP status. This allowed some of the more colorful MLPs to preserve their MLP structure.

Table 9: Some Grandfathered MLPs from the 1980s

Company	Ticker	Mkt Cap. ($MM)	Unit Price 3/26/02	Lines of Business	Main Assets
Boston Celtics	BOS	$30	$11.09	Manages operations for the Boston Celtics of the National Basketball Association	Partial ownership of the Boston Celtics
Borden Chemical & Plastics	BCPUQ	a	a	Produces polyvinyl (PVC) chloride resin products used in a wide variety of products	Two chemical plants in LA, one in IL
Cedar Fair b	FUN	$1,212	$23.50	Operates several theme parks, including its flagship park, Cedar Point, OH.	A total of 11 theme parks in the U.S.

Source: JPMorgan. a. BCPUQ is currently reorganizing under Chapter 11. It was adversely affected by rising natural gas prices last winter. b. JPMorgan rates FUN a Buy.

In 1997, Congress extended this exemption indefinitely with the stipulation that grandfathered MLPs be subject to a 3.5% tax on their gross income from partnership activities. Because of the uncertainty surrounding their status and the administrative costs of tracking tax matters for individual retail investors, many grandfathered MLPs have since changed their structure to that of a conventional corporation. This move also stemmed from the persistent valuation discrepancy between companies structured as MLPs and similar businesses structured as corporations. Different theories have been bandied about as to the reasons for this, from a lack of an institutional investor base to general investor qualms about MLPs.[4] We do not share the concerns about natural resource MLPs, as they have not exhibited valuation discrepancies and effectively use their tax-advantaged status to acquire assets.

Natural Resource MLPs Okay

Tax changes of the Tax Revenue Act of 1987 ensured that the MLP space would produce only "legitimate" MLPs to be sold to the public. Furthermore, many of the other problems that plagued MLPs in the 1980s no longer exist. MLPs used to be affected by a lack of liquidity in the secondary market. This is not true today, especially for larger market-cap MLPs. For much the same reason—small size and a lack of liquidity—Wall Street devoted few research capabilities to covering the MLP sector. As MLPs have grown in size, they have become less burdened by the costs of keeping track of investor costs and taxes.

Since MLPs occasionally come under the scrutiny of Congress, their tax-advantaged status may once again be reviewed and even altered. However, a number of factors lead us to believe it is very unlikely that natural resource MLPs will have their tax-advantaged status tampered with. In the first place, when Congress did curtail the permissibility of MLPs in the mid-1980s, there was an overriding concern that the rampant use of MLPs would deprive Congress of significant revenue sources. However, the limiting of the MLP structure by

[3] Falling under the definition of natural resource development are exploration, development, production, mining, refining (including fertilizers), marketing and transportation (including pipelines), of oil and gas, minerals, geothermal energy, or timber.
Congress made a distinction between tax shelter partnerships, which were non-traded partnerships intended to generate tax losses for their investors, and MLPs, which were always intended to generate (taxable) net income. The passive loss rules of the Tax Reform Act of 1986 were intended to address non-traded tax shelter partnerships.
There were also those in Congress and the administration who saw all MLPs—and, in some cases, even non-traded partnerships over a certain size—solely as tax avoidance mechanisms for businesses that should, in fact, be subject to corporate taxation. The rule passed in 1987 was a compromise based on the idea that real estate and natural resources were industries that had always raised capital through partnerships and that it was fitting for them to continue to raise capital in this fashion.

[4] Many MLPs changed to a corporate structure immediately following enactment of the Tax Reform Act of 198‾ including Apache Petroleum and Devon Resources (DVN/$47.52/Long-Term Buy).

Congress has dampened the concern about the loss of significant tax revenues, as the threat of "disincorporation" through the MLP structure has been restricted.

There are a number of additional reasons why we believe MLPs' favorable tax status is politically untouchable. Although they differ on the exact means of doing so, both Congress and the White House have stressed a need for the continued development of domestic energy sources and the energy infrastructure necessary to support such development.[5] Even in the mid-1980s, when Congress was extremely concerned about "disincorporation," it preserved the MLP structure for partnerships dedicated to natural resource development and infrastructure. We believe there is little reason to think that this attitude has changed. From the government's perspective, the MLP structure offers owners of midstream assets "compensation" for investments in low-growth, regulated businesses. The climate in Congress and in the White House is also now more energy-friendly than it has been in nearly a decade, and if projects like the Alaskan Pipeline are to be built, the MLP structure must be preserved and perhaps even enhanced.

Here Come the Institutions: Beneficial Legislative Changes

Under current law, ownership of publicly traded LP units in an MLP is restricted to individual retail investors. MLPs did not yet exist when the rules governing mutual funds were created. Income received from MLPs does not fall under one of the qualifying income sources allowable for mutual funds. If a mutual fund receives in excess of 10% of its income from MLPs, the mutual fund would be stripped of its special tax status. With the need to raise additional capital for energy assets, Congress is currently studying a proposal to allow MLPs to raise financing through the issuing of equity to mutual funds.[6] One MLP has already used an innovative structure to negate existing impediments to institutional MLP ownership. Combined with the legislation before Congress, these moves may mean that the MLP sector could see significant infusions of institutional capital soon, holding out the potential of higher MLP valuations and growth rates.

Kinder Morgan Energy Partners Raises Institutional Capital

Kinder Morgan Partners raised equity from institutional investors by structuring a deal to allow institutions to take an indirect interest in KMP. Kinder Morgan Inc., KMP's general partner, created a special class of securities for institutions, Kinder Morgan Management. KMR is a conventional corporation whose sole interest is investing in KMP. Institutional owners avoid the receipt of non-qualifying income by receiving share dividends instead of cash distributions, thereby upping their share in the partnership. Unlike individuals, institutions avoid having to file an annual K-1 form.

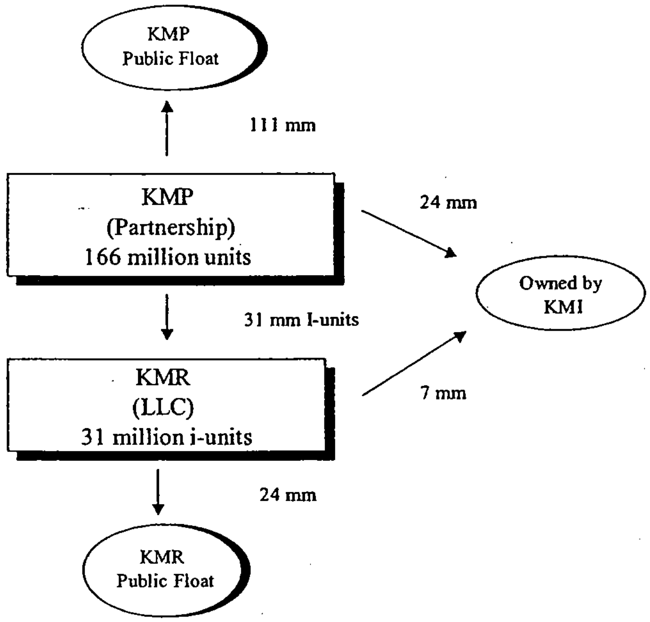
Each share of KMR is backed by an I share issued by KMP. This I share represents an interest in KMP proportional to a KMP LP unit.

[5] The Coalition of Publicly Traded Partnerships, the lobbying group for MLPs, has already positioned MLPs as a valuable way of increasing the nation's domestic energy assets in a post-September 11 world.

[6] The bill does not address the problem of tax-exempt institutional investors (such as universities and pension funds) owning MLPs. For tax-exempt institutions, any income from partnerships is treated as unrelated taxable business income. The Coalition for Publicly Traded Partnerships would like to address that issue in due time, although it is focused first on mutual funds.

I-Share is shorthand for "Institutional Share."

Figure 11: Entire Kinder Morgan Ownership Structure



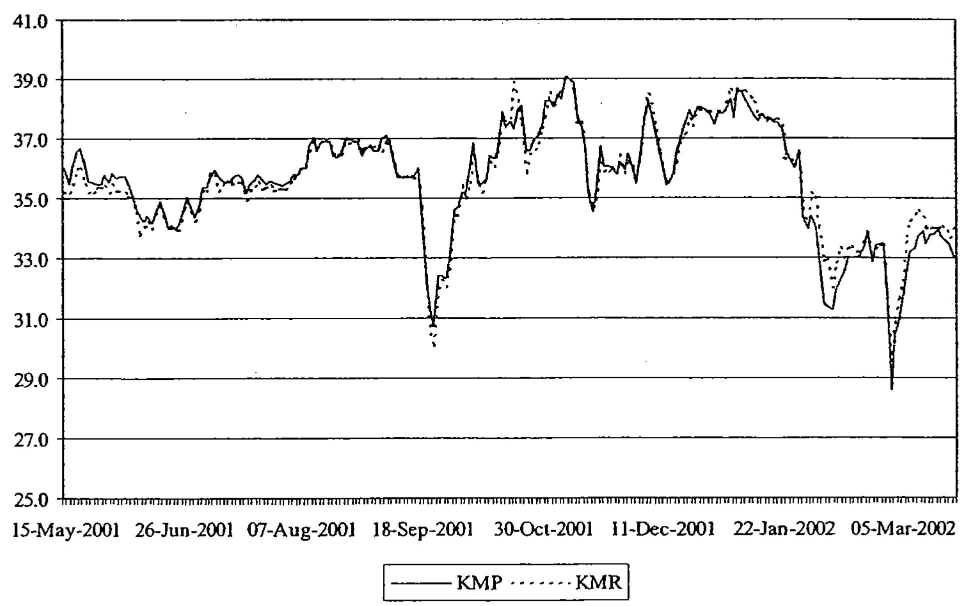
Source: Company reports.

KMP's and KMR's shares have tracked each other extremely closely since the KMR offering (see Figure 12). This is because of the feature allowing a one-to-one exchange between KMR's shares and KMP's LP unit. If investors demand an exchange from KMR to a KMP unit, KMI will execute the exchange with one of the KMP LP units it owns. Exchanges to date have been light, at less than 1% of the KMR shares issued, according to the company.

Thus far, KMP is the only MLP to have raised institutional capital.

Kinder Morgan completed its offering in May 2001. Despite the recent weakening in KMP's LP unit price, the company expects to complete another KMR issue in the first half of 2002, largely to fund its previously announced purchase of the Tejas Gas intrastate pipeline for $750 million.

Figure 12: KMP and KMR Have Tracked Each Other Closely



Source: FactSet.

Recent MLP Legislative Developments All Bode Well
The industry has proposed a bill (H.R. 1463/S. 1141) that would amend the tax code to treat income from MLPs as qualifying income for mutual funds. Industry lobbyists argue that there is no reason to treat MLPs any differently than other public securities, and we tend to agree. MLPs are regulated like equities and are subject to the same SEC filing requirements and regulatory oversight. At this point, MLPs compare favorably with other equity issues with the same market capitalization. Like common equity holders, limited partners do not actively participate in the management of the partnership. Indeed, besides tax treatment, it is difficult to find practical differences between shareholders in a conventional corporation and MLP LP unit holders.

We view the regulatory climate as increasingly favorable to MLPs, and we think that MLPs may be able to raise equity directly from institutions in the near future. A similar bill already passed Congress in 1999 as part of the Taxpayer Refund and Relief Act of 1999 (H.R. 2844), but it was vetoed by President Clinton. The bill has again been submitted to Congress, with sponsorship from Senator Gramm (R-TX) and co-sponsorship from Senators Grassley (R-IA), Murkowski (R-AK), and Nickles (R-OK), and it could be attached to the fiscal stimulus bill just passed by the House or to an energy bill. Although our assessment of the MLP sector is not contingent upon Congress allowing institutional investors to invest in MLPs, an amendment to current law would give MLPs access to a large pool of capital that has been previously off limits. MLPs could then fund a more rapid rate of asset acquisition, accelerating their growth rates and reinforcing our bullish outlook on the sector. However, absent such regulation, we believe the outlook for MLPs is still favorable.

MLP Miscellany

Not for Your Retirement Accounts or Non-U.S. Relatives
Since MLPs produce what is known as "unrelated business taxable income," MLPs are not allowed to be owned by tax-exempt entities and are therefore not appropriate investments for tax-sheltered accounts, such as IRAs and 401(k)s. Non-U.S. citizens should avoid purchasing MLPs lest they be viewed as doing business in the United States, which would subject them to a number of special tax laws.

Minimum Quarterly Distribution Agreements
An MLP has an agreement with its GP to provide publicly traded unit holders with a minimal level of distributions, guaranteed by the GP, prior to distributing any cash to the GP.[7] These support agreements, know as minimum quarterly distributions, last for a finite period of time, until certain cash distribution levels are achieved. However, such agreements do add to the generally conservative nature of today's MLPs, and they further align incentives between GP and LP unit holders. MLPs should not trade on whether their subordination period is still effective, but an MLP whose support agreement is about to expire may assume a higher risk premium, with investors demanding higher yields as compensation for the additional risk. Different MLPs have different minimum quarterly distribution agreements.

What About Enron and Its Impact on MLPs—Including Its Own Two MLPs?

Enron's failure has cast a pall over the merchant energy sector, as many of its major players have been subjected to rigorous examinations of their balance sheets and credit standings. Many players have announced balance sheet restructurings to consolidate off-balance-sheet obligations and restore investor confidence. These restructurings have included intentions to sell more than $2 billion worth of midstream energy assets, the bulk of which will probably end up in MLPs. In theory, the unit prices of those MLPs with either a GP looking to divest

[7] If the MLP is unable to meet the specified minimum level of distribution, publicly traded unit holders have arrearage rights and are entitled to prior distributions promised but not paid (much like preferred stock). The GP does not have arrearage rights.

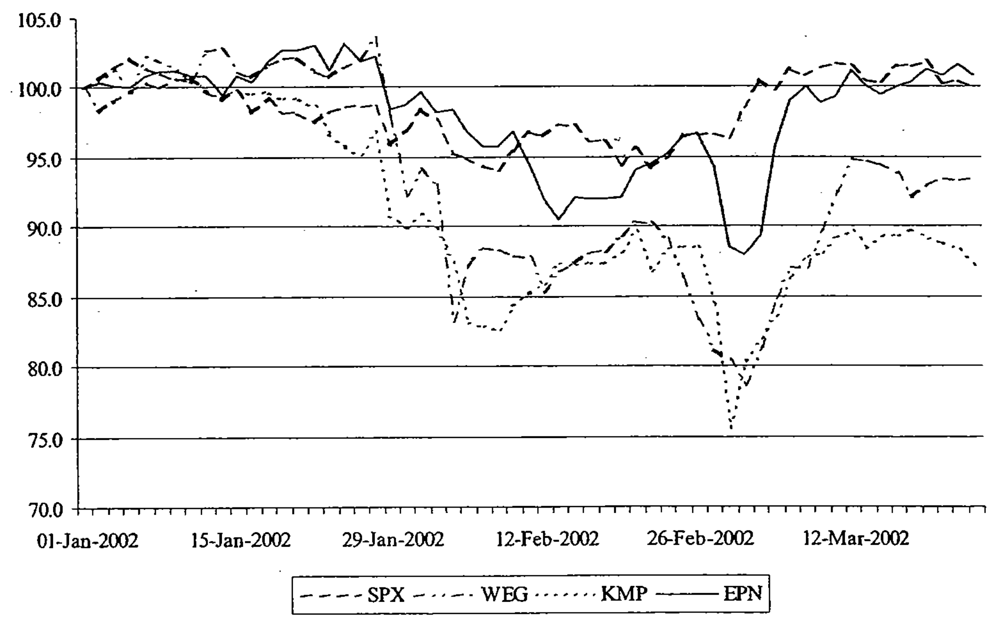
midstream assets, or an MLP with the financing firepower to acquire assets being divested, should have bright prospects.

Contrary to these theories, such MLPs have seen a decline in their unit prices since the beginning of 2002. The following is a list of MLPs involved in announced asset divestitures:

- We believe El Paso Energy Partners, whose GP, El Paso Corp., has announced a $2.25 billion asset divestiture program as part of its larger balance sheet restructuring program, could benefit from announced asset divestitures. El Paso Energy Partners has already negotiated to acquire $750 million worth of these assets.
- Williams Energy Partners, whose GP, Williams Companies, has announced potential asset divestitures of $250-750 million, stating that it intends to divest some of these assets to Williams Energy Partners.
- Dynegy, which has announced its intention to sell up to $250 million worth of midstream assets to a newly created MLP in which Dynegy will be the GP.
- Kinder Morgan Energy Partners, which is the largest MLP by market capitalization but lacks a GP with a large dowry of assets. KMP has expressed interest in some of the assets being divested by Williams Companies.

Despite these bright prospects on the acquisition front for MLPs, units of certain MLPs have underperformed since the beginning of the year, as shown in Figure 13.

Figure 13: Certain MLPs Have Underperformed in 2002



Source: FactSet.

Unlike MLPs, Energy marketing and trading operations are governed by FAS 133, where trading positions are marked to market to reflect a position's current profit or loss, even though a position is still outstanding.

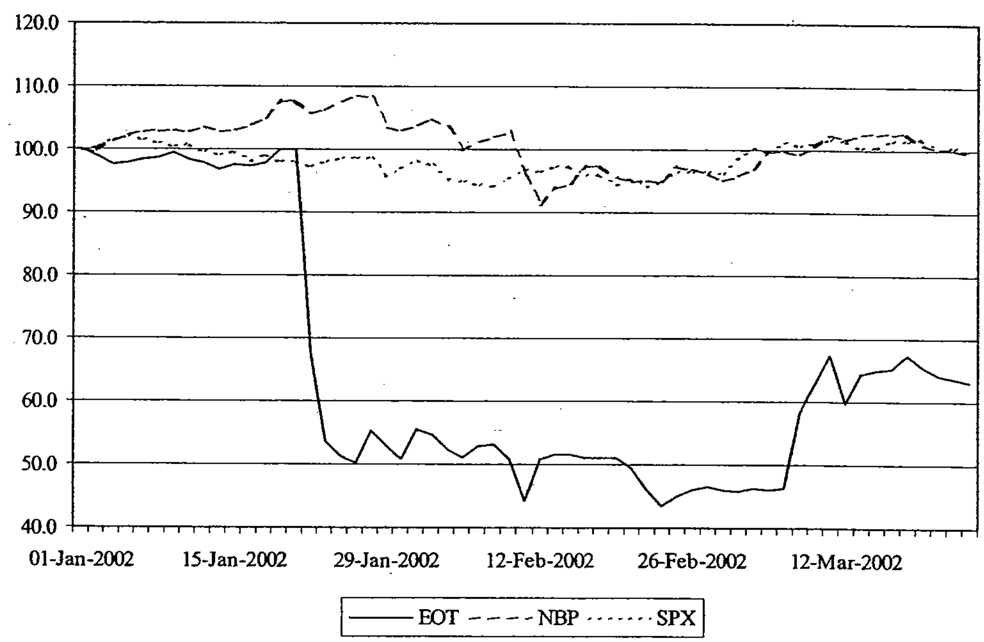
We think that MLPs are being unfairly lumped together with their general partner merchant energy peers. Unlike their GPs, MLPs do not engage in energy trading activities, nor are they exposed to the same commodity risk as some of their parents that are involved in commodity exploration and production.

We believe MLPs are insulated from the energy risk management services offered by larger merchant energy players. Since MLPs do not engage in marketing and trading, they do not have any mark-to-market accounting on their books. Although we do consider mark-to-market accounting appropriate for merchant energy players, it has bedeviled investors in its complexity. It cannot be stressed enough that MLPs do not use this accounting treatment. In fact, as strictly asset-based companies, MLPs are relatively straightforward in their accounting practices. We do not believe the Enron fallout should extend to LPs. If anything, the balance sheet restructurings announced in the merchant energy sector will in all likelihood hasten the divestiture of MLP qualifying assets into MLPs.

EOTT Energy Partners vs. Northern Border: A Cautionary Tale

Although MLPs differ vastly from their merchant energy counterparts, Enron's bankruptcy has directly affected two MLPs, but in very different ways. Enron is the general partner in two MLPs, Northern Border Partners and EOTT Energy Partners.

Figure 14: Same General Partner, Big Difference in Performance



Source: FactSet.

Northern Border Partners Largely Unaffected—Despite also having the same general partner in Enron,[8] Northern Border Partners was largely unaffected by Enron and its subsidiaries' declaration of bankruptcy. The two Enron subsidiaries that are the official GPs in Northern Border were among the Enron entities that filed for bankruptcy.

Contracts with EGLI Not Too Hot for EOTT—However, EOTT did not emerge from the Enron bankruptcy unscathed. Its business is heavily focused on the transporting and storing of crude oil. Although EOTT itself did not file for bankruptcy as a subsidiary of Enron, one of

[8] WMB is co-general partner of NBP with Enron, although WMB's GP stake is 0.4% and Enron's GP stake is 9.

its primary customers was Enron Gas Liquids, Inc. (EGLI). Among the assets that Enron placed into EOTT in a July 2001 $120 million transaction was a hydrocarbon processing plant in Texas. In connection with the sales, EGLI entered into a 10-year tolling agreement for production from the processing complex. EGLI did file for bankruptcy as part of Enron's bankruptcy and has been unable to perform on part of its contractual tolling arrangement with EOTT. To make matters worse, the contract has been part of the bankruptcy court proceedings, preventing EOTT from entering into another tolling arrangement for the plant.

As a result of the EGLI developments, as well as heightened concern on the part of EOTT customers, EOTT has slashed its quarterly distribution from $0.475 to $0.25 per unit, well below its stated minimum distribution requirements. EOTT has filed a claim as part of Enron's bankruptcy case for the difference between the minimum distribution requirement and EOTT's current payout.

Conclusion—The lesson to be learned from EOTT and Northern Border lies in examining the structure and contractual obligations of an MLP's cash flows. Northern Border, exercising controlling stakes in large and extensive pipelines, markets capacity on the pipelines to a variety of market players. However, EOTT was stuck with a tolling agreement solely with Enron, and clauses in the agreement did not contain an opt-out option in the case of an EGLI bankruptcy filing. When analyzing an MLP, it is important to determine the nature of the GP's relationship with its MLP: whether it is supplying its assets in divestitures and whether it is then the customer of those assets supplying the MLP with its operating cash flows. As a matter of principal, we are most comfortable with MLPs with large diversified asset bases.

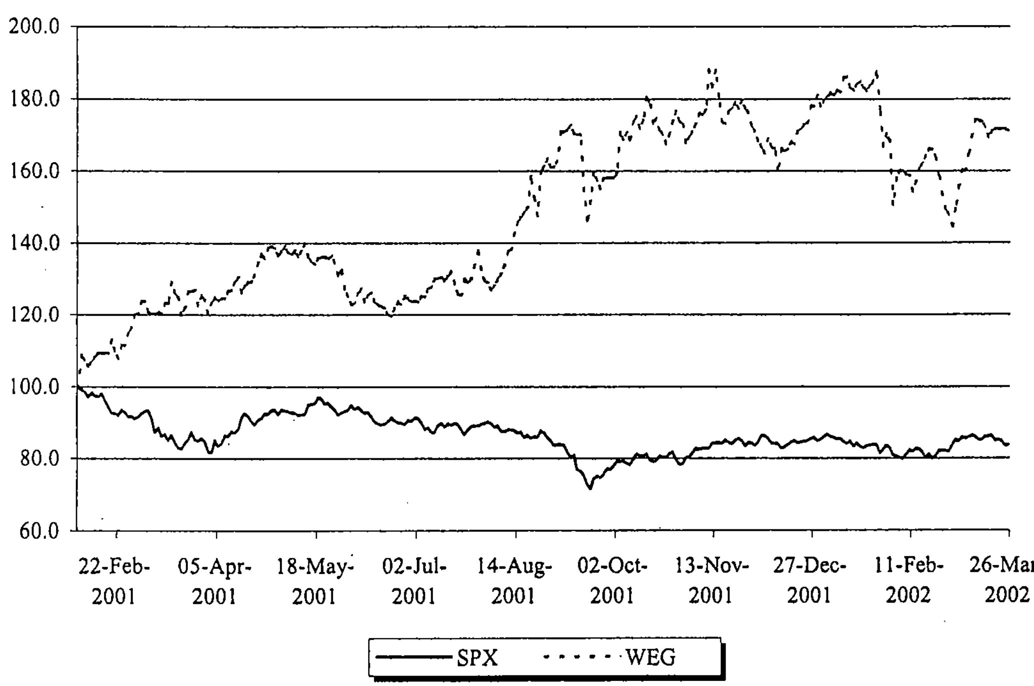
APPENDIX I: SAMPLE MLP PROFILES

Williams Energy Partners
WEG (NYSE)

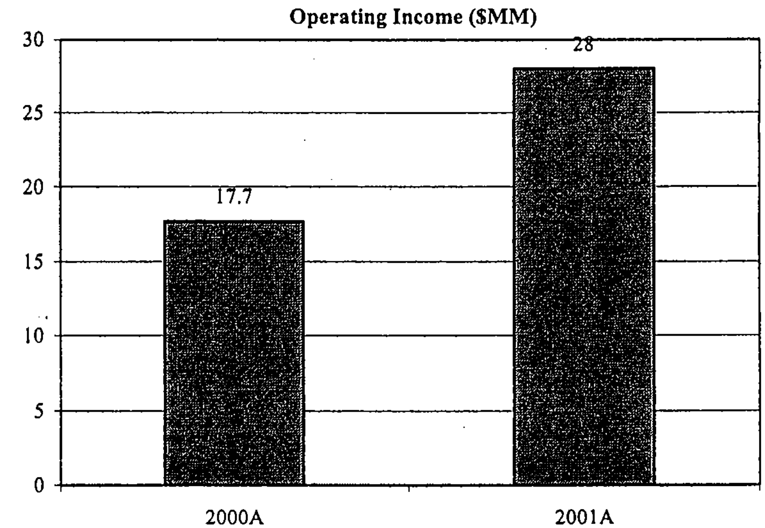
- Williams Energy Partners began trading in February 2001. Williams (WMB) is the partnership's GP and has a significant interest in WEG through its 57% limited partner interest and 2% general partner interest.
- WEG's current asset portfolio consists of 5 marine petroleum terminal facilities, 25 inland petroleum terminals and an ammonia pipeline and distribution system. WEG's terminal facilities are primarily spread throughout the southeastern United States.
- WEG may see a significant growth in its asset base with WMB's intention to divest a large portion of its midstream energy assets. Placing these assets in WEG would make sense for WMB.

Note: Data for WEG from company reports and FactSet.

WEG vs. S&P 500 – 1-Year Performance



Market Capitalization: $441.9MM
Firm Value: $574.6MM
Number of LP units outstanding: 11.36MM
Unit Price (3/26/02): $38.90
Distribution per LP unit (A)/Current Yield: $2.36/6.1%
Debt/Book Capitalization: 38.3%



Williams Energy Partners LP
Incentive Distribution Agreement

	Per LP Unit	% to GP	% to LP	Tier
Minimum Quarterly Distribution	$0.000 - $0.525	2%	98%	1
	$0.526 - $0.578	2%	98.00%	2
Incentive Compensation Agreement	$0.579 - $0.656	15%	85.00%	3
	$0.657 - $0.788	25%	75.00%	4
	>$0.788	50%	50.00%	5

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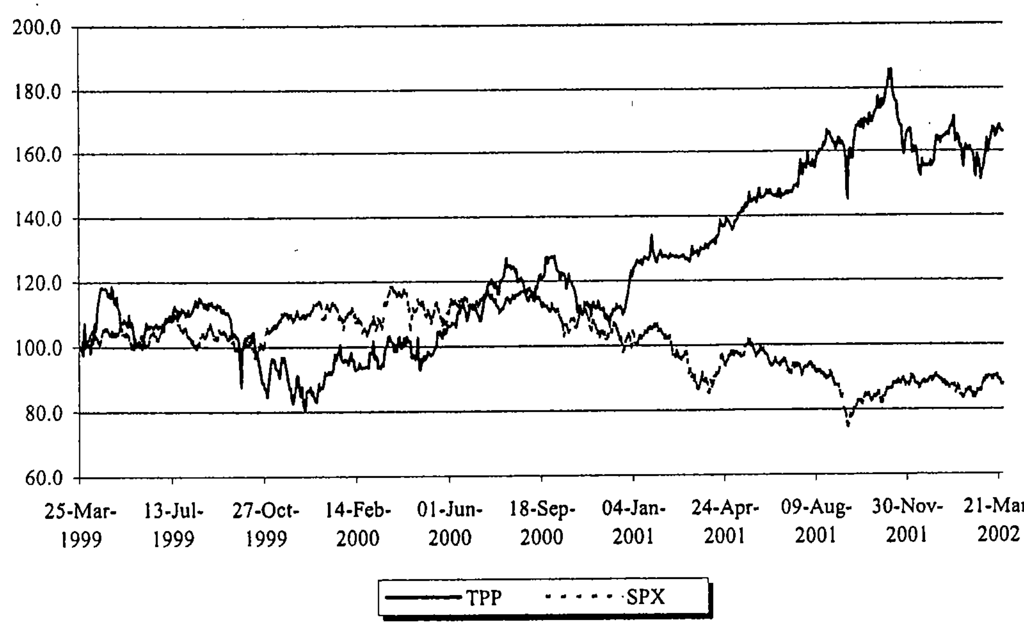
anatol.feygin@jpmorgan.com

TEPPCO Partners
TPP (NYSE)

- TEPPCO has operated as an MLP for over a decade, having gone public in March 1990. Duke Energy Field Services, a division of Duke Energy (DUK/$37.07/Long-Term Buy), is TEPPCO's General Partner, with a 70% GP interest. Phillips (P/$61.38) owns the remaining 30% GP interest.
- TEPPCO owns and operates one of the largest petroleum products pipelines in the country that extends from Texas through the Midwest to destinations in the Northeast. Among other assets, it owns and operates an NGL pipeline system based primarily in Texas. It also owns and operates terminals along each of the pipeline systems.
- In the fourth quarter of 2001, TEPPCO closed on its acquisition of the Jonah Gas Gathering System located in the Green River Basin for $360MM from Alberta Energy. The acquisition was TEPPCO's first entry into the Natural Gas gathering business, away from its traditional focus on crude products.

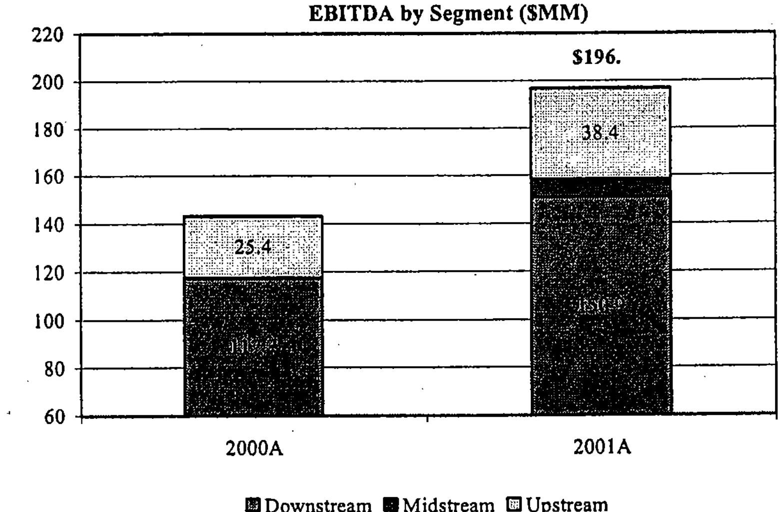
Note: Data for TPP from company reports and FactSet.

TPP vs. S&P 500 – 3-Year Performance



Market Capitalization: $1,263.7MM
Firm Value: $2,328.7MM
Number of LP units outstanding: 40.5MM
Unit Price (3/26/02): $31.24
Distribution per LP unit (A)/Current Yield: $2.30/7.4%
Debt/Book Capitalization: 62.4%

EBITDA by Segment ($MM)



Teppco Partners LP
Incentive Distribution Agreement

	Per LP Unit	% to GP	% to LP	Tier
Minimum Quarterly Distribution	$0.000 - $0.275	2%	98%	1
	$0.276 - $0.325	15%	85.00%	2
Incentive Compensation Agreement	$0.326 - $0.450	25%	75.00%	3
	>$0.450	50%	50.00%	4

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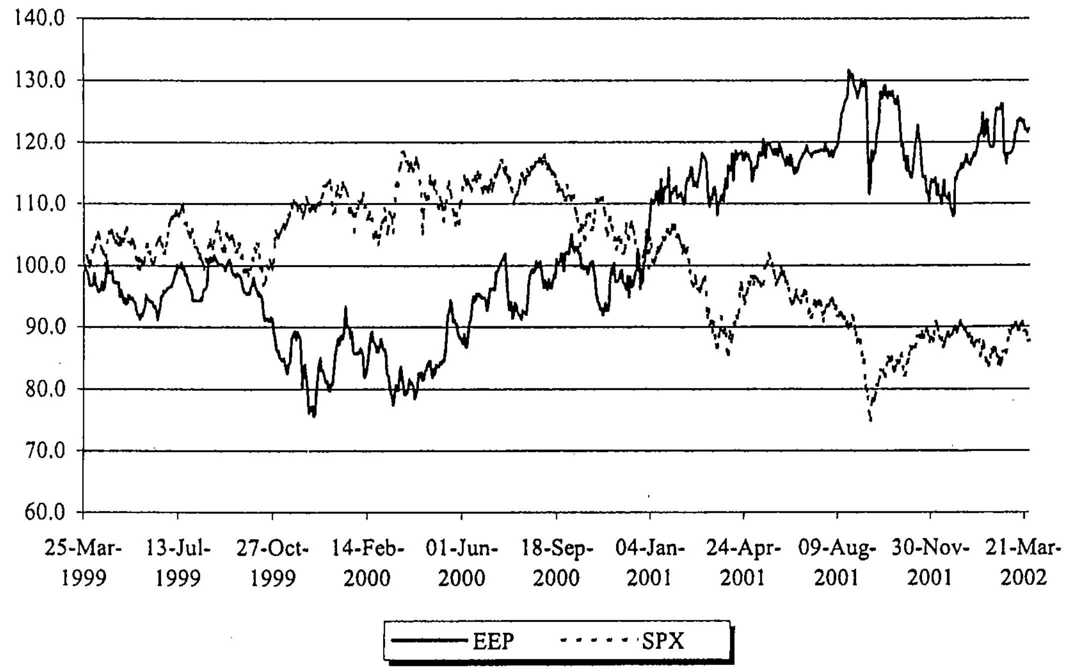
Enbridge Energy Partners
EEP (NYSE)

- Enbridge Energy Partners has operated as a Master Limited Partnership since December 1991 and is headquartered in Houston, TX. Its General Partner is Enbridge Inc.
- The Enbridge Energy pipeline system extends from North Dakota through Michigan, with an extension through to Buffalo, NY. The pipeline system transports petroleum and also has three different petroleum tank storage facilities located along the system.
- In October 2001, the partnership agreed to purchase natural gas gathering and processing assets in east Texas.

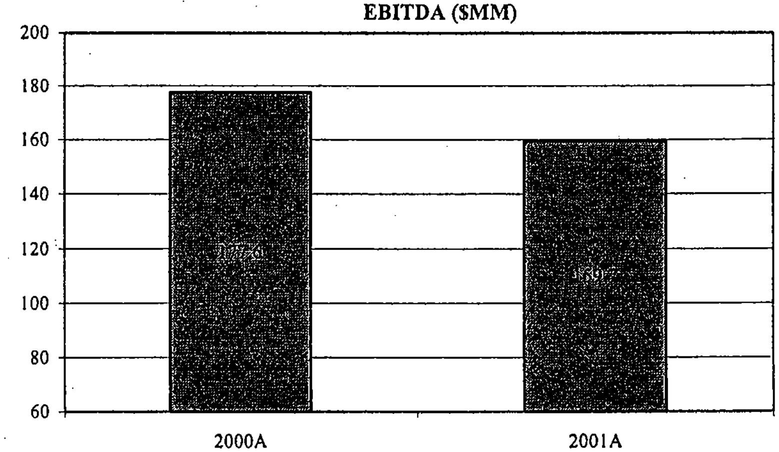
Note: Data for EEP from company reports and FactSet.

EEP vs. S&P 500 – 3-Year Performance



Market Capitalization: $1,452.5MM
Firm Value: $2,307.2MM
Number of LP units outstanding: 33.0MM
Unit Price (3/26/02): $44.06
Distribution per LP unit (A)/Current Yield: $3.60/8.2%
Debt/Book Capitalization: 57.9%

EBITDA ($MM)



Enbridge Energy Partners LP
Incentive Distribution Agreement

	Per LP Unit	% to GP	% to LP	Tier
Minimum Quarterly Distribution	$0.00 - $0.59	2%	98%	1
	$0.60 - $0.70	15%	85.00%	2
Incentive Compensation Agreement	$0.71 - $0.99	25%	75.00%	3
	>$0.99	50%	50.00%	4

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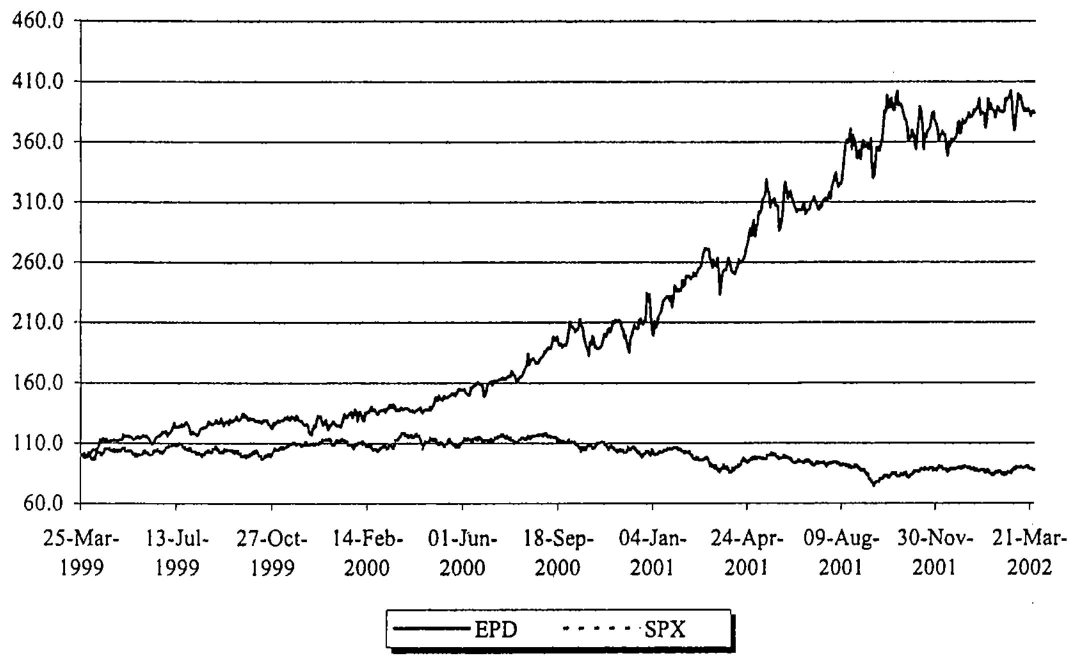
anatol.feygin@jpmorgan.com

Enterprise Products Partners
EPD (NYSE)

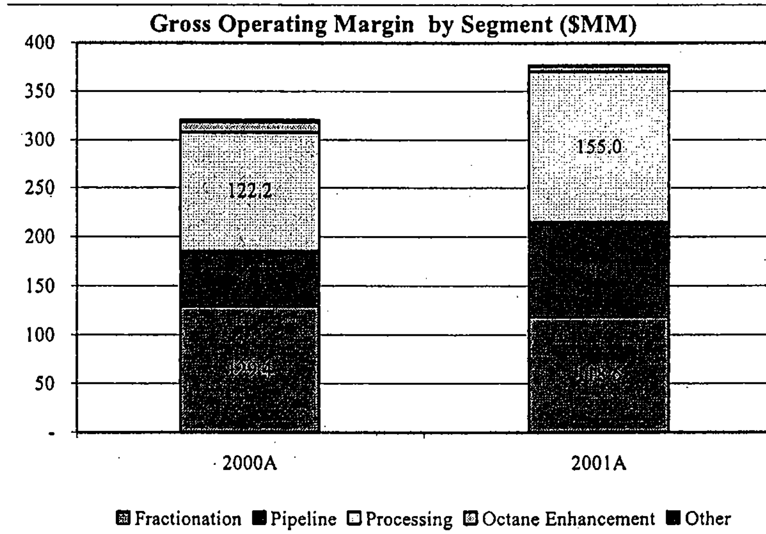
- Enterprise Products Partners went public in 1998, but the partnership has been in operation since 1968, as a wholesale marketer of natural gas liquids.
- Enterprise Products is primarily involved in the transportation of natural gas and natural gas liquids. It owns 4 natural gas pipeline systems in the Gulf of Mexico and 12 natural gas processing plants backed by a natural gas processing agreement with Shell.
- The partnership also owns an NGL import/export facility located on the Houston Ship Channel and connected via pipeline to a natural gas processing facility.

Note: Data for EPD from company reports and FactSet.

EPD vs. S&P 500 – 3-Year Performance



Market Capitalization: $4,156.7MM
Firm Value: $4,885.9MM
Number of LP units: 87.3MM
Unit Price (3/26/02): $47.63
Distribution per LP unit (A)/Current Yield: $2.50/5.2%
Debt/Book Capitalization: 42.5%



Enterprise Products Partners LP
Incentive Distribution Agreement

	Per LP Unit	% to GP	% to LP	Tier
Minimum Quarterly Distribution	$0.000 - $0.506	2%	98%	1
	$0.507 - $0.617	15%	85.00%	2
Incentive Compensation Agreement	$0.618 - $0.784	25%	75.00%	3
	>$0.784	50%	50.00%	4

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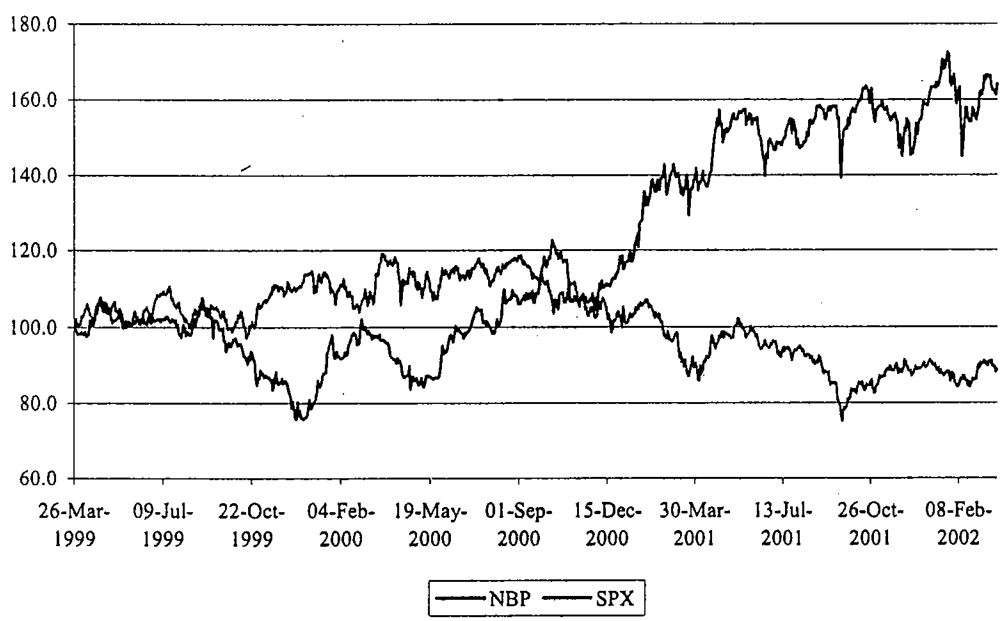
Northern Border Partners
NBP (NYSE)

- Northern Border Partners was formed in 1993. Its General Partners are Williams and Enron. Please see page 25for a full discussion of the effects of Enron's bankruptcy on the partnership.
- The partnership owns a 70% interest in the Northern Border Pipeline Co., a 1,214-mile natural gas pipeline system that transports Canadian natural gas into the United States for import.
- Northern Border also wholly owns a 350-mile Midwestern Gas Transmission natural gas pipeline system that extends from Portland, TN to Joliet, IL. Northern Border purchased the system in May of 2001 for $100MM from El Paso Corporation.
- The partnership also has extensive interests in the Powder and Wind River Basin natural gas producing areas of Wyoming in both traditional natural gas gathering activities and in coalbed methane gathering.

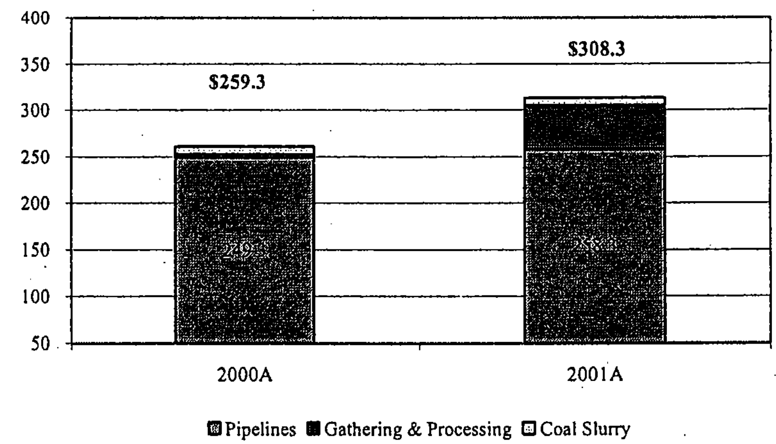
Note: Data for NBP from company reports and FactSet.

NBP vs. S&P 500 – 3-Year Performance



Market Capitalization: $1,643.6MM
Firm Value: $3.301.3MM
Number of LP units outstanding: 41.62MM
Unit Price (3/26/02): $39.49
Distribution per LP unit (A)/Current Yield: $3.20/8.1%
Debt/Book Capitalization: 54.8%

EBITDA by Segment ($MM)



Northern Border Partners LP Incentive Distribution Agreement				
	Per LP Unit	% to GP	% to LP	Tier
Minimum Quarterly Distribution	$0.000 - $0.605	2%	98%	1
	$0.606 - $0.715	15%	85.00%	2
Incentive Compensation Agreement	$0.716 - $0.935	25%	75.00%	3
	>$0.935	50%	50.00%	4

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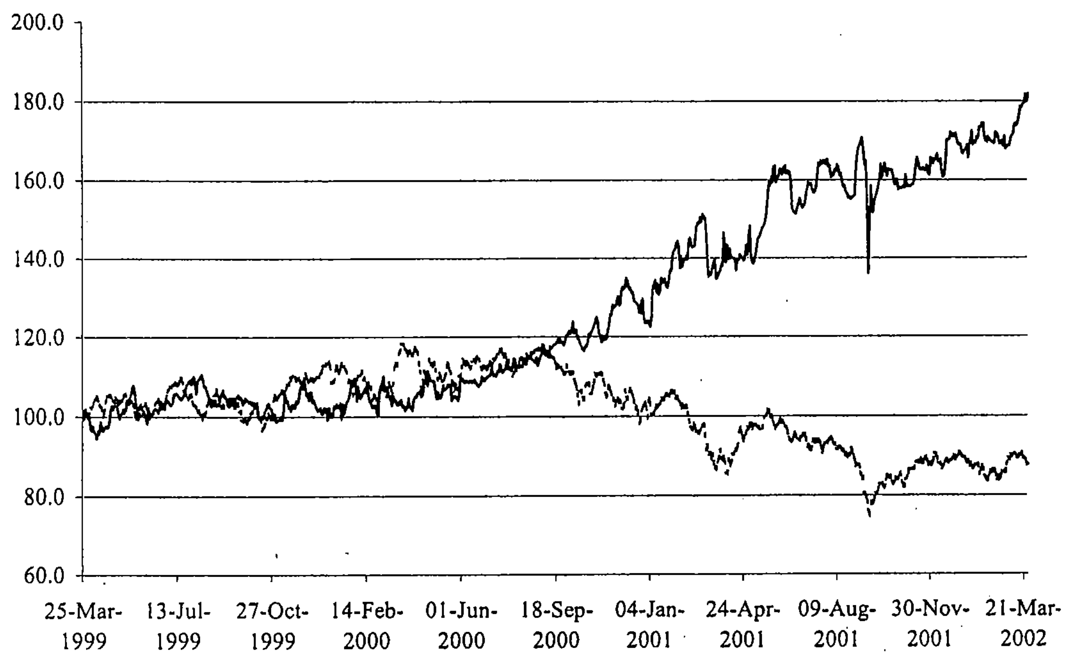
anatol.feygin@jpmorgan.com

Buckeye Partners
BPL (NYSE)

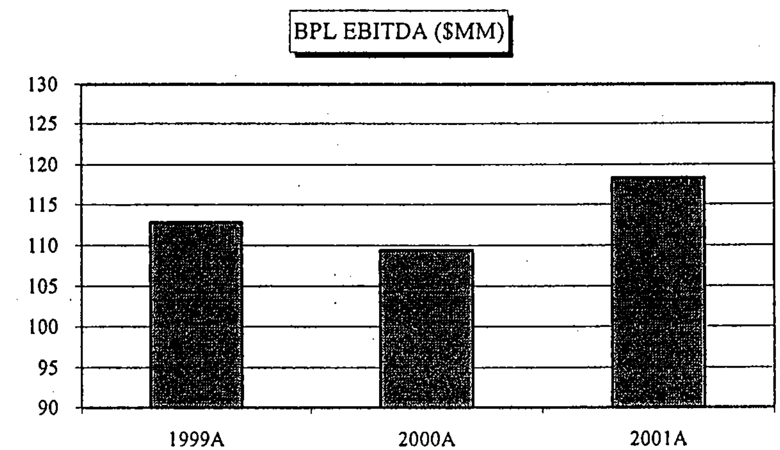
- Buckeye Partners was reorganized into a Master Limited Partnership in 1986. The employees and management of Buckeye Partners bought out the general partner interest in 1996.
- The partnership provides pipeline transportation services for jet fuel, gasoline and other petroleum products to major markets on the East Coast and in the Midwest.
- Buckeye services the three major New York City airports with jet fuel. It also has extensive storage terminals located at various strategic delivery points along its pipeline network.

Note: Data for BPL from company reports and FactSet.

BPL vs. S&P 500 – 3-Year Performance



Market Capitalization: $1,047.0MM
Firm Value: $1,380.7MM
Number of LP units outstanding: 26.92MM
Unit Price (3/26/02): $38.90
Distribution per LP unit (A)/Current Yield: $2.50/6.4%
Debt/Book Capitalization: 49.1%



Buckeye Partners LP Incentive Distribution Agreement

	Per LP Unit	% to GP	% to LP	Tier
Minimum Quarterly Distribution	$0.000 - $0.325	1%	99%	1
Incentive Compensation Agreement	$0.326 - $0.350	15%	85.00%	2
	$0.351 - $0.375	25%	75.00%	3
	$0.376 - $0.425	35%	65.00%	4
	$0.426 - $0.525	40%	60.00%	5
	>$0.525	45%	55.00%	6

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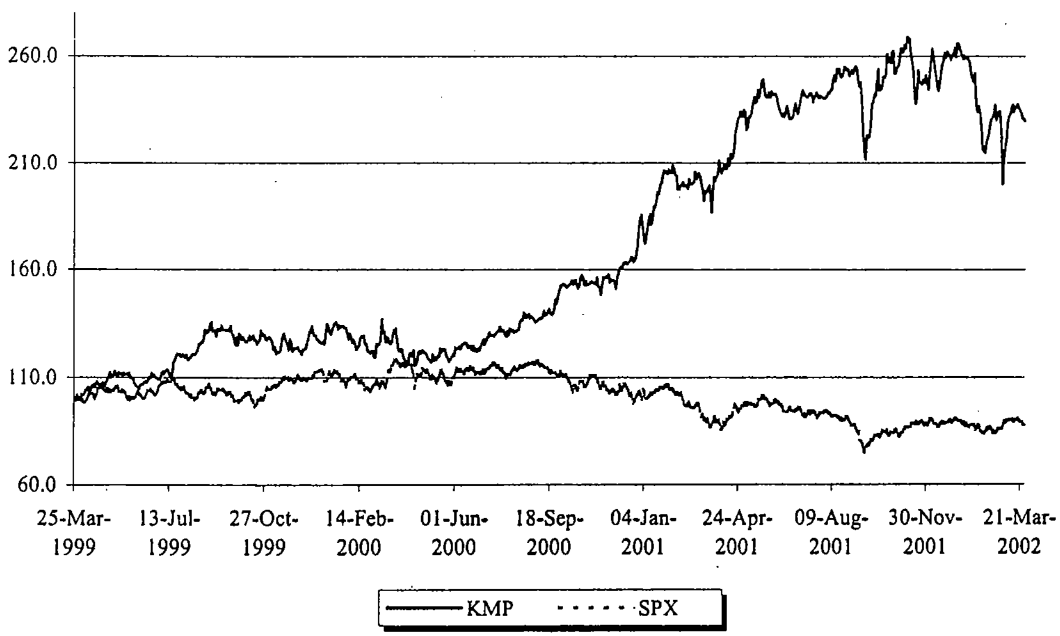
Kinder Morgan Energy Partners
KMP (NYSE)

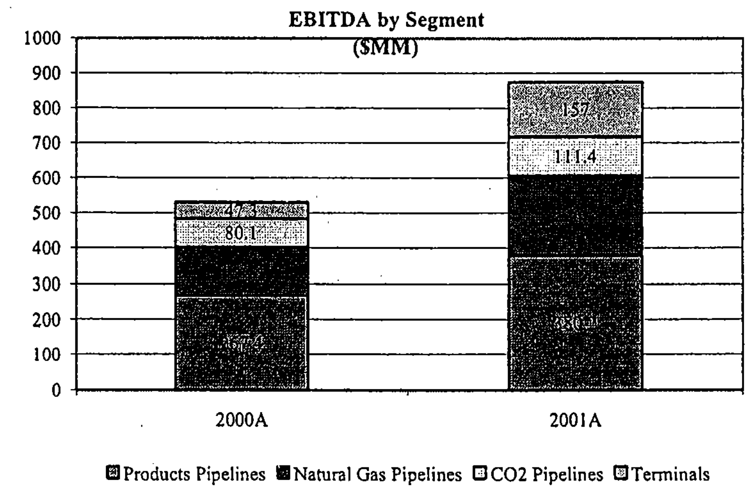
- Kinder Morgan Energy Partners was formed in February of 1997 when a group of investors acquired the general partnership interest in what was then known as the Enron Liquids Limited Partnership. The name of the partnership was then changed to Kinder Morgan and the partnership maintains no relationship to Enron.
- KMP is the United States' largest pipeline Master Limited Partnership and has completed several large asset purchases since 1997. These include the 1998 $1.4B acquisition of Santa Fe Pacific Pipeline Partners and the $1.15B acquisition of the U.S. terminals and pipeline assets of the GATX corporation that was completed in March 2001.
- KMP's latest large acquisition was the purchase of the 3,400 mile natural gas intrastate pipeline system known as the Tejas Gas Pipeline System for $750MM and located in Texas.

Note: Data for KMP from company reports and FactSet.

KMP vs. S&P 500 – 3-Year Performance



Market Capitalization: $5,463..MM
Firm Value: $8,257.5MM
Number of LP units outstanding: 129.8MM
Unit Price (3/26/02): $32.95
Distribution per LP unit (A)/Current Yield: $2.50/6.7%
Debt/Book Capitalization: 46.4%



Kinder Morgan Energy Partners LP Incentive Distribution Agreement				
	Per LP Unit	% to GP	% to LP	Tier
Minimum Quarterly Distribution	$0.0000 - $0.3025	2%	98%	1
	$0.3026 - $0.3575	15%	85.00%	2
Incentive Compensation Agreement	$0.3576 - $0.4675	25%	75.00%	3
	>$0.4675	50%	50.00%	4

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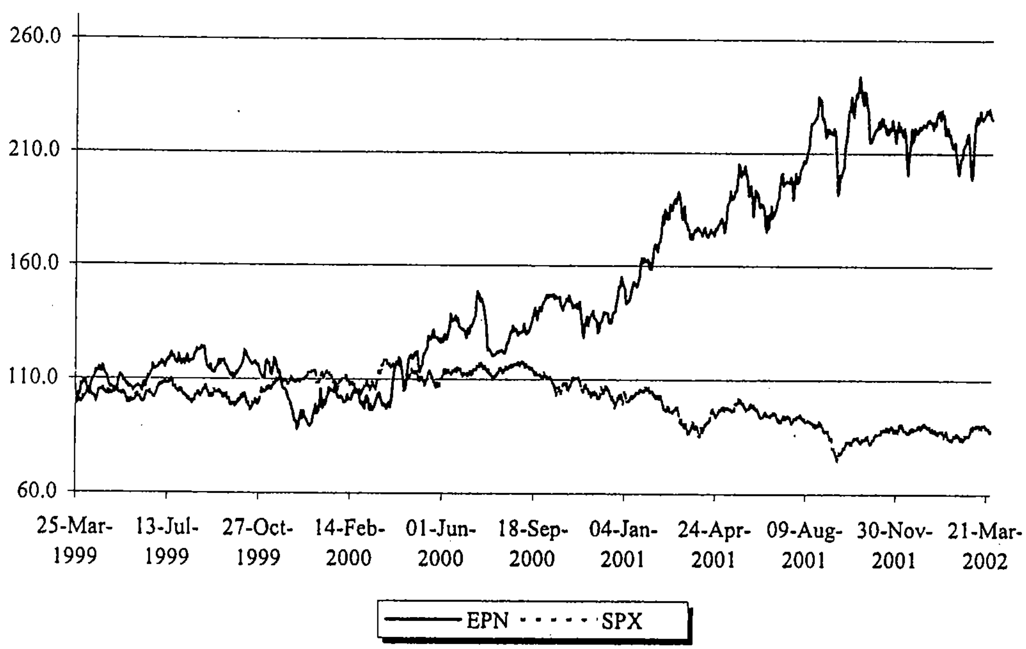
Equity Research
Anatol Feygin (1-212) 622-6448
anatol.feygin@jpmorgan.com

El Paso Energy Partners
EPN (NYSE)

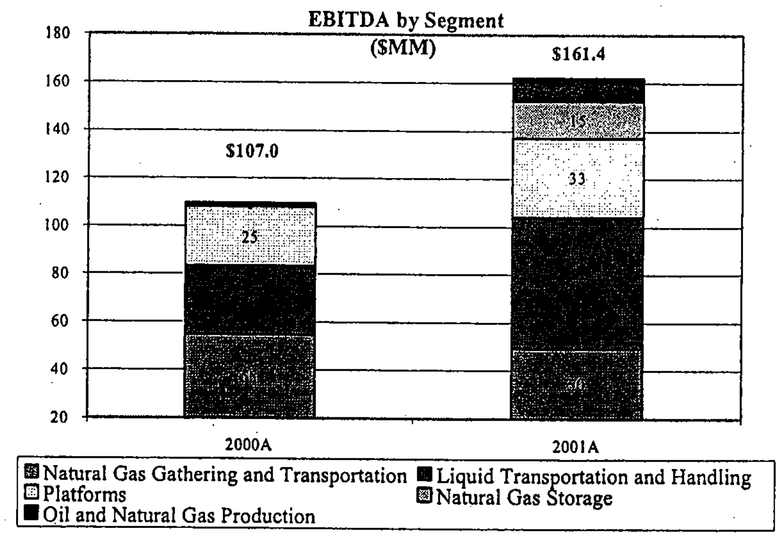
- El Paso Energy Partners was formed in 1998 when the El Paso Corporation bought the General Partnership Interest in the Leviathan Gas Pipeline Partnership and subsequently changed its name to El Paso Energy Partners in November 1999 to reflect its relationship with its General Partner.
- EPN currently contains assets in five areas: Natural Gas Gathering and Transportation Systems, Liquid Transportation Handling, Natural Gas Storage, Platforms and Oil and Natural Gas Production. In order to grow, it considers both acquiring outside assets and the development of internal projects.
- The partnership has acquired a significant amount of assets from its General Partner, El Paso Corporation. Its latest significant asset acquisition announcement, EPN will acquire the EPGT Texas Intrastate Pipeline for a total purchase price of $750MM from El Paso Corporation. The assets include a Texan intrastate natural gas pipeline, a gathering system in the Permian Basin and an interest in a natural gas processing plant.

Note: Data for EPN from company reports and FactSet.

EPN vs. S&P 500 – 3-Year Performance



Market Capitalization: $1,46.4MM
Firm Value: $2,418.2MM
Number of LP units outstanding: 39.74MM
Unit Price (3/26/02): $36.95
Distribution per LP unit (A)/Current Yield: $2.50/6.8%
Debt/Book Capitalization: 62.1%



El Paso Energy Partners LP
Incentive Distribution Agreement

	Per LP Unit	% to GP	% to LP	Tier
Minimum Quarterly Distribution	$0.000 - $0.325	2%	98%	1
	$0.326 - $0.375	15%	85.00%	2
Incentive Compensation Agreement	$0.376 - $0.425	25%	75.00%	3
	>$0.425	50%	50.00%	4

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J.P. Morgan Securities Inc.
Equity Research
Anatol Feygin (1-212) 622-6448
anatol.feygin@jpmorgan.com

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