Rich Kinder's Energy Kingdom

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Energy

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Richard Kinder, November 2012. (Photo crec Matt Hawthorne)

The most important man in the American Energy Boom wears brown slacks and a checkered shirt and sits in a modest corner office with unexceptional views of downtown Houston and some forgettable art on the wall. You would expect to at least see a big map showing pipelines stretching from coast to coast. Nope. "We don't have sports tickets, we don't have corporate jets," growls Richard Kinder, 68, CEO of Kinder Morgan, America's third-largest energy firm. "We don't have stadiums named after us."

That last line was a not-so-veiled poke at the last energy giant to dominate Houston, Enron, where Kinder served as president before Ken Lay nudged him aside in favor the now incarcerated Jeffrey Skilling. Kinder Morgan is in many ways an Enron do-over. Enron ultimately manipulated energy as ephemeral chits in a global trading game--a fraudulent one at that. Kinder Morgan's focus is far more tangible, and honest, encompassing 75,000 miles of pipe and 180 storage terminals capable of handling 2.5 million barrels of oil and 55 billion cubic feet of gas a day. Its publicly traded entities total $100 billion in enterprise value (equity plus debt).

Still better, the company is solely focused on North America during the most important oil and gas boom in 50 years. Thanks to technologies like hydraulic fracking and horizontal drilling, oil production in the U.S. is already up to 6.2 millio barrels per day from 5 million bpd in 2008; natural gas production remains at a record high near 65 billion cubic feet per day. When that fuel moves anywhere, Kinder extracts a taste.

"We have the economies of scale, the footprint around the country," Kinder says of his sprawling toll road. "We access virtually every producing basin, whether for natural gas or crude oil, in the U.S. and Canada."

That positions Kinder Morgan eerily well for the coming decades. By 2020, predicts the International Energy Agency, domestic oil output could grow to 11 million bpd, meaning the U.S. would replace Saudi Arabia as the world's top producer. Analysts see the need for $20 billion in new pipeline construction a year for the next five year Trucks and trains aren't a viable alternative. Kinder and other pipeline operators charge about $5 to send a barrel of oil across the country. You'd spend around $10 a barrel via rail, or $20 by truck.

Kinder already has $10 billion in announced projects and plans to build new pipes, reroute others and gobble up more competitors, as he did with El Paso Corp., acquired this year for $38 billion. One plan in the works calls for reconfiguring lines to help oil companies get natural gas liquids (like propane) from fields in southern Texas all the way north to Alberta, Canada, where it's used to dilute the thick tar sands, which are then carried over Kinder's pipeline to tankers on the Pacific Coast (bypassing the controversial route of the Keystone XL pipeline) . He's also angling tc export cheap American natural gas via two terminals picked up from El Paso to fuel-starved markets like Japan and Korea. "What Kinder Morgan is doing in regard to acquiring lines and expanding capacity is vital to American growth," says Ed Hirs, a lecturer in energy economics at the University of Houston.

If successful, Kinder, already the richest man in Houston and 36th on The Forbes 4c with a personal net worth of $8.6 billion, would become far, far richer. "He's a force of nature; his whole genetic makeup is to be a leader," says John Edwards of Credit Suisse, which has helped finance Kinder for years. Now comes the hard part: executing on this vision. Kinder says he's ready: "All the capital allocation comes through the office of the chairman, comes through me."

Far from the oil patch, Kinder grew up in the land of Mark Twain, paper route and a He was born in Cape Girardeau, Mo., on the banks of the Mississippi. His dad was a insurance salesman and his mother a schoolteacher. He served in Vietnam as an Army captain, attended the University of Missouri and got a law degree. The 1970s were rocky. He filed for bankruptcy in 1980 after a bad investment in a Howard Johnson's (though he later repaid his debts in full).

Married, with a daughter, and scrambling to keep financially afloat, he talked to a college friend, Bill Morgan, who was working with another Missouri buddy of theirs, Ken Lay, at Houston Natural Gas. Morgan suggested that Kinder get a job at Florida Gas to learn the pipeline business. He did, and when Houston Natural Gas acquired Florida Gas in 1984, Kinder and Lay were reunited . By 1990 Kinder had risen to president of the newly christened Enron, with Lay as chairman and CEO. The two were a powerful team, growing the company from revenues of $5.7 billion in 1991 to $13.3 billion in 1996.

Kinder expected Lay to hand him the Enron CEO mantle and move upstairs to the chairman's office, but the board blindsided him. Thinking Kinder was too much of a fuddy-duddy, too wedded to the fading pipeline business and lacking the swashbuckling style needed to run a company so clearly destined to remake the worlds of dealmaking an energy trading, they withheld the top job. Kinder left at the end of 1996. Lay replace him with Jeffrey Skilling and held on to the CEO office.

"If Kinder had stayed on as president, Enron would still be here," says Richard Smead, a veteran industry executive now a consultant at Navigant. Others find it ha to believe that Kinder didn't know anything about the fishy financial engineering tha eventually killed the company in late 2001. Kinder dismisses that idea. "I left Enron five years before it imploded and was just as surprised as everyone else at the company's demise," he says.

No matter. Soon after leaving Enron, Kinder heard from Bill Morgan again, who was angling to acquire some tired old pipelines and a terminal that Enron wasn't using anymore. For an equity investment of $40 million Morgan and Kinder took control assets worth $325 million. Kinder Morgan was born.

In the years before the shale boom, Kinder and Morgan (since retired) unlocke magic by taking a sleepy corporate structure known as the master limited partnershi and reinventing it as a growth vehicle. MLPs, as they're known, simply hold long-lived, income-producing assets. They usually have no employees or offices (all of tha is handled by the general partner), and crucially, they don't pay corporate taxes. All profits and tax liabilities are passed on to unitholders. (Kinder's own pretax distributions top $100 million a year.)

"Our idea, Bill Morgan's and my idea, was that we could take that and we could operate them very efficiently with laser focus so our whole game would be assets," Kinder says. "We wouldn't be in the trading business."

Because of their tax treatment MLPs enjoy a lower cost of capital than regular corporate structures. Kinder could buy pipelines from non-MLP owners, drop them into the Kinder Morgan Energy Partners MLP, squeeze out costs and immediately increase free cash flows. "They are notorious for not spending money," says Smead. "If you want to fly first class, you have to pay for it yourself," says Kinder.

Aside from Kinder Morgan Energy Partners (KMP) there's Kinder Morgan Inc., whi holds 100% of the general partner interests that wield control over the MLP and ow units of the MLP. It's known by its ticker symbol, KMI. There's also Kinder Morgan Management (KMR), which is functionally equivalent to KMP but allows shareholders to receive distributions in new shares instead of cash.

It's convoluted, but since many pipelines are regulated by the federal government, Kinder and his team are mostly glorified maintenance workers and toll takers. "If yo own a toll road, you don't care how many passengers are in each car or what kind of car it is," says Kinder. "You just want as many cars to move down the road as possibl and you make damn certain they pay their tolls, okay?"

Better than okay, especially in an era of rock-bottom interest rates and investors chasing yields . Since 1996 KMP unitholders have seen distributions increase every single year at a compound annualized rate of 14%. Over the past decade the KMP issue has generated total returns of 350%, royally besting the 83% return on the S&I 500.

The drawback: "The trouble with the pipeline business is that these assets are immovable, long-lived and expensive," says Smead. "Committing capital to a snapshot view of the future is a risky business."

Despite Kinder's best efforts, back in 2006 the market wasn't adequately appreciatir the value of Kinder Morgan Inc. With shares of KMI trading at $84, Kinder announced he would lead a group that included Goldman Sachs, Riverstone Holdings, the Carlyle Group and Highstar Capital to buy out the company for what ended up being $107.50 a share, or $21 billion. The deal valued Kinder's 18% stake i KMI at about $2.4 billion. The company was renamed Knight Inc.

When the LBO was completed the U.S. shale-drilling boom had barely even begun. That soon changed. Surging oil and gas prices, to $147 a barrel and $14 per thousan cubic feet in the summer of 2008, unleashed a flurry of drilling across the U.S. that led to the development of shale plays like the Bakken, Marcellus, Haynesville, Fayetteville, Eagle Ford, Niobrara, Utica and on and on.

The boom sent demand for new pipelines soaring. That couldn't have been more fortuitous for Kinder and his LBO partners, who in early 2011 took Knight public again, under its old Kinder Morgan name. The IPO raised $2.3 billion, all of which went into the pockets of the buyout group. Kinder, who had wrangled his stake in Knight up to 31%, emerged with the value of his holdings more than doubled to $6.6 billion.

For all of Kinder's seeming foresight, he's had some missteps. By the time of the Knight buyout, construction was already well under way on a $6.8 billion, 1,700-mile pipeline from Colorado to the Eastern Seaboard called Rockies Express. Kinder Morgan led the project, designed to bring cheap Colorado gas into the most expensiv market in the country.

"But it was conceived before the Marcellus Shale was a twinkle in anybody's eye," sa Edwards. "Now the pipeline is like bringing sand to the beach." The beach is the Marcellus Shale, stretching across New York and Pennsylvania, and is considered th nation's biggest natural gas field. More recently, the Utica Shale has been drilled in neighboring Ohio.

Also, back before the shale boom, Kinder invested $950 million in building a high-grade 42-inch-diameter pipeline leading from Cheniere Energy's liquefied natural ga import terminal at Sabine Pass in Louisiana. It was thought at the time that the U.S. would need an influx of LNG from countries like Qatar to make up for a coming domestic gas shortfall. Now, of course, there's so much gas that drillers have simply stopped drilling some fields. "The world changes. That's why you don't bet the ranch on any one project," says Edwards. And why, says Kinder, you always lease out pipeline capacity to customers before you build.

Kinder recently sold its stake in Rockies Express for a loss but isn't torn up about it; the divestiture satisfied Federal Trade Commission concerns about the El Paso acquisition. Now, to supply the Northeast, Kinder is leveraging El Paso's 13,000-mil Tennessee pipeline network that flows from Corpus Christi clear through to Boston.

Kinder Morgan also operates the only pipeline that carries tar sands crude out of Alberta over the Rocky Mountains to its tanker terminal in Vancouver. Kinder acquired the Trans Mountain Pipeline in 2005 and now seeks to expand it from 300,000 barrels per day to 750,000 bpd by building a new $4 billion pipe alongside the first. He's already signed up nine oil companies eager to fill the proposed line wi their crude.

Environmentalists are fighting the plan, as well as the similar Northern Gateway Project proposed by Canada's Enbridge, and, of course, they hate the Keystone XL line--blocked by President Obama last January--that TransCanada wants to build to bring more oil sands crude into the U.S. and ultimately down to Gulf Coast refinerie

If environmentalists don't like Kinder's Trans Mountain expansion, they'll despise h new plan to help export 100,000 barrels a day of natural gas liquids (like propane) from the Eagle Ford Shale in southern Texas to Alberta. There, the NGLs are used to dilute tar sands so they can flow through pipelines.

Making it work will require regulatory approval and $225 million of engineering to reverse the direction of Kinder's north-to-south Cochin pipeline, but Kinder's so confident it can be done that he's already signed up two oil companies to 15-year contracts. "In the end it will be approved," he says of his--and other--oil sands pipelines. "But I'm not naive. recognize it's a long process."

A new business for Kinder is liquefied natural gas. With the El Paso deal came two liquefied natural gas terminals in Elba Island, Ga. and Pascagoula, Miss. They were built for LNG imports, but Kinder is reconfiguring them and has already received permits to export LNG. Producers will jump at the chance to ship gas to the likes of Japan and Korea, where it can fetch upwards of $12 per thousand cubic feet. You can buy the same amount of gas in Louisiana today for $3.70, a tasty spread.

But will what's good for Kinder Morgan be good for America? If all the proposed LN projects get done it would give the U.S. the ability to export 20 billion cubic feet of g per day, or about a third of current supplies. This could cause U.S. prices to skyrock Some politicians, like Representative Ed Markey (D-Mass.), want to block LNG exports altogether, insisting U.S. gas would better serve America if it remains at hon to keep prices low.

This frustrates Kinder. Despite supporting presidential hopeful Mitt Romney, he thinks many politicians--including Romney, Obama and Markey--are out to lunch when they talk about the U.S. being somehow "energy independent." "If people thin we can draw a circle around North America and that we can be an independent islan of energy, that's not realistic," says Kinder. "This is a world market for oil, for refine products and increasingly for natural gas."

Having the option of exporting gas will put a floor under gas prices, he says, and tha will protect drillers, producers--and the country--from painful boom-and-bust cycle

Of course, it would also help Kinder Morgan move a great deal more gas. If Kinder's leviathan has an Achilles' heel, it's that the company is deeply leveraged to oil--not just moving it but producing it. In Texas Kinder Morgan's wells produce more oil than any company but Occidental Petroleum--53,000 barrels a day. Indeed, the division with the highest return on investment in the Kinder empire (26% in 2011) provides carbon dioxide for oil companies and itself to inject into old fields to goose out stubborn oil. In recent years the oil and CO 2 business has generated 30% of Kinder Morgan's Ebitda. So much for Kinder's assertion that the company is only a little bit exposed to commodity prices.

Oilfields and natural CO2 reservoirs are not like MLP-style toll roads at all. They're declining assets that will be able to maintain cash flows only if commodity prices increase. "If we were going to create the ultimate MLP, we wouldn't include an oil ar CO2 business," says Curt Launer, pipeline analyst at Deutsche Bank. "That said, Ric Kinder has been the visionary in this industry."

Kinder defends his choices. "Look, I have billions of dollars of value in this company I've never sold a share. I've bought more every time I can get a chance. I bought 20 million more shares last November. If we didn't pay these dividends my wife might say, 'Hey, wait a minute.'"

There's the even bigger question, of course: What happens to these pipelines--and Kinder Morgan--when we've used up all that newly found oil and gas?

Kinder brushes the idea aside. "I think that for any of our lifetimes fossil fuels are going to be the primary source of energy in this world. When you talk the shale plays we have at least 100 years of supply. I'm a huge believer in the genius of mankind, and I think we'll continue to find new ways to utilize, explore for and produce more and more fossil fuels."

That, he says, is why there will be a role for his company as far into the future as he can see--and why he keeps buying up as many of its shares as he can. No matter how much fuel gets pulled from the ground, "if we don't have the infrastructure to get it t market," he says, "we're out of luck."

The Pipe Barons: Whether Alive Or Dead, These Are The Billionaires Shaping America's Pipeline Network

Kelcy Warren

-- His Energy Transfer Partners has been on a tear, buying up Southern Union and Sunoco this year. Warren's net worth: $2.3 billion. Former partner Ray Davis has $1 billion.

-- 45,000 miles of pipelines

Dan Duncan

-- When Duncan died in 2010, he left control of Enterprise Products Partners to his four children: Scott Duncan, Randa Williams, Dannine Avara and Milane Frantz. Each is worth $4.3 billion.

-- 50,700 miles of pipelines

Koch Brothers

-- The empire owned by Charles and David (net worth: $31 billion, each) operates refineries and fertilizer plants and trades commodities worldwide.

-- 4,000 miles of pipelines

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