



# INVESTMENT PARTNERS ASSET MANAGEMENT

One Highland Avenue, Metuchen NJ 08840 Tel: 732-205-0391 Fax: 732-205-0395

---

## **BY FAX AND OVERNIGHT MAIL TO ADDRESSEE**

September 2, 2010

Board of Managers  
Attention: Mr. Steven R. Brunner  
Constellation Energy Partners, LLC  
1801 Main Street  
Suite 1300  
Houston, Texas 77002

### **Re: Concerns Regarding Our Clients' Investment in Constellation Energy Partners**

Dear Sirs:

We wish for 2010 to be the year that Constellation Energy Partners ("CEP" or the "Company") restores market value and income production to its unitholders. Toward this end, this letter serves as our expression of both comment and concern to the Board of Managers regarding the mission and direction of the company.

The clients of my firm, Investment Partners Asset Management, its affiliates, and/or other clients for whom our employees serve as brokers beneficially own approximately 217,000 units (or slightly less than 1% of the outstanding units) of CEP. This includes 70,000 units held by the Investment Partners Opportunities Fund. As you know, over the past few years, there has been a steep decline in the market price of CEP's units, but there appears to be some price stability at around \$3.00/unit (a price that represents only about 16% of stated book value per unit). While we recognize that a portion of the loss in market value reflects the decline in natural gas prices over the intermediate term, we also believe that there may be other contributory factors. We wish to summarize our thoughts and concerns about the company in a constructive manner.

### **Departure from CEP's Strategy / Distribution Policy**

The mission of CEP has been consistently stated on multiple occasions by the company in its public filings and in various investor forums. Indeed, under the *Business Strategy* section on page 2 of your original S1 filing on June 14, 2006 it states that "(your) primary business objective is to generate stable cash flows allowing (you) to make quarterly cash distributions to (your) unitholders and over time to increase the amount of (your) future quarterly distributions by executing (your) business strategy..." In your 2008 10K filing (filed February 27, 2009) you reiterated that "(your) primary business objective is to generate stable cash flows allowing (you) to make quarterly cash distributions to (your) unitholders. In the long term, (you) are focused on increasing the amount of our future quarterly distributions over time." Finally, that same filing on page 64 you went on to state that "(you) estimate that (you) will have sufficient cash flow from operations after funding (your) maintenance capital expenditures to enable (you) to make quarterly cash distributions payable to unitholders through December 31, 2009, as set by (your) Board of Managers. (Your) future quarterly distribution rate to unitholders has not been announced, but (you) anticipate that any future distribution rates will be set at a sustainable level." Our initial and subsequent purchases of your securities were predicated on these and other such representations.

While we have noticed modest improvements in efficiency and costs of production in recent quarters, we feel CEP's unit price has been negatively impacted by some of CEP's initiatives – particularly as they pertain to your distribution policy. Unitholder cash distributions previously were \$0.5625 per quarter from the third quarter of 2007 through the third quarter of 2008. You then reduced distributions to \$0.13 per unit for the fourth quarter of 2008, and the most recent distribution you have paid was another \$0.13 per unit (for the first quarter of 2009) on May 15, 2009. CEP then suspended distributions for the balance of 2009, and as you wrote in your most recent quarterly report, “the company previously announced that it expects distributions will remain suspended through the fourth quarter of 2010 and until after such time that debt levels are reduced and market conditions again warrant resumption of capital spending at maintenance levels.” Your recent 10Q filing demonstrated total members equity of approximately \$466 million and debt of \$180 million (which is below 90% of your current borrowing base of \$205 million). With roughly 24.5 million units outstanding, members equity equates to \$19.00 per unit, while the unit trades around \$3.00. Against that background, we find it difficult to understand that CEP's net book value is unable to support some level of cash flow distributable to unitholders.

We recognize that much of the cash flow stability is generated by the ability of CEP to sell its production into the future and deliver natural gas into those hedges. In fact, another reason we made the decision to invest in CEP was your strategy of funding distributions for unitholders by selling your production at predetermined price levels over a three to five year period. We note that the current price deck which exists in the futures market for natural gas on the NYMEX exchange is roughly 75%-80% of the prices at which CEP has hedges currently in place (upon which you were formerly able to distribute \$0.5625/unit quarterly prior to your decision to reduce it to \$0.13/unit quarterly and then further reduce it to \$0.00/unit quarterly.) We believe that the magnitude of your stated distribution cut is not commensurate with the decline in the forward market in natural gas, and slashing the quarterly distribution from \$0.5625/unit/quarter to \$0.13/unit/quarter to \$0.00/unit/quarter does not represent cash flow stability for unitholders.

### **Increased Expenses for Management**

As you disclosed in an 8K filed on May 4, 2009, four of CEP's senior management executives entered into new employment agreements with the company last year. (This announcement was followed roughly 7 and ½ weeks later, by a subsequent 8K filing on June 26, 2009, that income distribution to unitholders would be suspended pursuant to the terms of CEP's credit agreements.) In addition to salaries, these employment agreements contemplate participation in a newly-adopted 2009 Omnibus Incentive Compensation Plan, the granting of units of the company under a Grant Agreement, Inducement Bonuses, Enhanced Severance Amounts under certain circumstances, and other items. While some of the terms of these compensation agreements may be justified, we noticed that in the case of the Chief Financial Officer, and the Chief Executive Officer positions that the salary components nearly doubled over the levels disclosed in your 2008 10K filing dated February 27, 2009. Raising salaries to this magnitude given the depressed market value of CEP's units and subsequent suspension of distributions creates a question in our minds since we believe that management compensation should be correlated to market-value creation and production of income distributions for unitholders.

## **Relationship with CEP's Largest Owner and Former Sponsor, Constellation Energy Group (CEG)**

As you are aware, Constellation Energy Group (CEG) was the founder and/or sponsor of CEP from the company's inception in 2005 through the termination of their services agreement on December 15, 2009. The market value diminution that occurred on CEG's watch is very considerable. While it has exited its role as CEP's sponsor (and in the process removed itself from day-to-day management), we feel that CEP's stated goal of generating stable cash flows to allow for quarterly distributions was not advanced during CEG's tenure. While it would seem logical to us that, as a large owner, CEG would want to maximize the value of its investment and be responsive to the issues facing the company, we note on page 160 of CEG's 2009 10K that CEG took a \$34.2 million after tax charge in Q3 of 2009, and a \$50.6 million after tax charge in Q4 of 2009 in relation to its investment in CEP. In other words, it appears that CEG has written down its investment in CEP significantly. Given its exit as sponsor and substantial write down of its investment, at this point it is difficult for us to believe that CEG is willing to do much proactively to assist CEP in restoring value and fulfilling the company's stated strategy. If that is the case, then we feel you should be seriously concerned about any further involvement CEG might have as a continued investor in the company. In short, we think that if CEG is not interested in assisting CEP to restore value and income production to unitholders then it should consider selling its large stake in the company to someone who is perhaps willing to help management and the Board unlock value.

## **Relationship with CEP's Banking Syndicate**

It is also our view that the company continues to be plagued by a continually diminishing line of credit from its banking syndicate. Since CEP currently has a debt to equity ratio in the 35-40% range, we think there should be other banks willing to provide financing to the company on favorable terms. While the current credit crisis has been difficult to navigate, it seems to also represent an opportunity for CEP to seek an investment-banking solution to remove prior relationships which are not assisting the company achieve its mission to unitholders. Simply put, we believe that you should find another lending source that is more flexible than the one you have now. Having said that, we feel strongly that CEP should not assume further debt in order to buy more natural-resource properties until meaningful and sustainable income distributions have been restored to unitholders.

## **Possible Corporate Finance Solutions**

We believe that corporate-finance initiatives represent the most efficient solution to restore value and income production to unitholders. We therefore recommend the Board retain an investment banking firm immediately and, in doing so, suggest that you consider hiring a firm that is not conflicted by competing energy-industry relationships and retentions. Below are some potential ideas to consider:

We feel that one reason the unit price is depressed is the overhang of CEG's large stake in CEP. Given its exit as CEP's sponsor and the write down of its investment, it appears to us that CEG does not wish to proactively assist CEP in accomplishing its strategy. If that is indeed the case, one manner by which you could potentially improve the situation is by finding a buyer for CEG's units now, and possibly allowing CEG the right to "spring back" into the company by granting them warrants at a higher strike price (say \$7.00 or \$8.00/unit). That way CEG may be able to get liquidity, realize its loss, and relieve the market of its overhanging position.

Another possibility is to strengthen CEP's balance sheet by means of a rights offering to current holders. If CEP were successful in raising approximately \$50 million at current prices, the company would have roughly 40 million units, and the debt could be paid down to \$130 million. We believe this would likely place CEP well within its loan covenants set by the current lending syndicate and could accommodate the reinstatement of a meaningful ongoing distribution rate for unitholders. Specifically, after raising capital in this way, we think the company might be able to pay out 66% of EBITDA and thus distribute roughly \$1.00/unit annually. In relation to CEP's peers, and adjusting for a discount relative thereto, we believe the unit price could approach \$10.00 with a 10% yield under such a scenario.

If you, however, believe that the rights offering represents an unfavorable cost of capital, an additional option the company could consider is replacing the lending syndicate through a convertible debt issue with warrants, offered to current unitholders and others, that could supply investors with a coupon, liquidity, and upside potential to both new and prior stakeholders.

Another alternative, of course, would be for CEP to simply to merge with or sell itself to another publicly-traded master limited partnership. We are aware of a number of energy-related MLP's which have raised capital to shore-up their balance sheets and continue to pay cash distributions to their unitholders.

## **Conclusion**

The original mission of CEP was to produce energy resources and pay stable cash flow payments to its unitholders. With the continued suspension of the quarterly distribution, we think that among the only constituents of CEP who are currently deriving a benefit from its existence are the company's creditors and its employees. It's time to include the unitholders in that equation. Maintaining the status quo just won't do.

Sincerely,

Gregg T. Abella  
Co-Principal  
Investment Partners Asset Management

cc: Mr. Mayo A. Shattuck, III, Executive Chairman, Constellation Energy Group  
Mr. Arthur Grossman, Esq. – Mandelbaum Salsburg  
Ms. Joanne Strasser – Thompson Hine