EL PASO CORP/DE
Form 10-Q/A
July 08, 2005

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q/A
(Amendment No. 1)

(Mark One)
[X]

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2004
OR

[ ]

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number 1-14365

El Paso Corporation
(Exact Name of Registrant as Specified in its Charter)

Delaware	**76-0568816**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
El Paso Building 1001 Louisiana Street Houston, Texas	**77002**
(Address of Principal Executive Offices)	(Zip Code)

Telephone Number: **(713) 420-2600**
Internet Website: www.elpaso.com

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes o No þ

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes þ No o

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Common stock, par value $3 per share. Shares outstanding on December 16, 2004: 643,194,441

EL PASO CORPORATION
TABLE OF CONTENTS

Caption	Page

Below is a list of terms that are common to our industry and used throughout this document:

/d	= per day
Bbl	= barrels
BBtu	= billion British thermal units
Bcf	= billion cubic feet
Bcfe	= billion cubic feet of natural gas equivalents
MBbls	= thousand barrels
Mcf	= thousand cubic feet
Mcfe	= thousand cubic feet of natural gas equivalents
MMBtu	= million British thermal units
MMcf	= million cubic feet
MMcfe	= million cubic feet of natural gas equivalents
TBtu	= trillion British thermal units
MW	= megawatt

When we refer to natural gas and oil in equivalents, we are doing so to compare quantities of oil with quantities of natural gas or to express these different commodities in a common unit. In calculating equivalents, we use a generally recognized standard in which one Bbl of oil is equal to six Mcf of natural gas. Oil includes natural gas liquids unless otherwise specified. Also, when we refer to cubic feet measurements, all measurements are at a pressure of 14.73 pounds per square inch.

When we refer to us , we , our , ours , or El Paso , we are describing El Paso Corporation and/or our subsidiaries

Table of Contents

EXPLANATORY NOTE

As disclosed in our 2004 Annual Report on Form-K, as amended, our 2004, 2003 and 2002 financial statements were restated for several matters. Our 2002 financial statements were restated to reflect a correction in the manner in which we adopted Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*. Our 2003 and 2004 financial statements were restated to reflect adjustments resulting from errors in the accounting and reporting for foreign currency translation adjustments (CTA) and related tax adjustments. This Form 10-Q, as amended, is being filed to reflect the effects of those restatements in our historical financial statements interim period ended September 30, 2004. For a further discussion of these restatements, see our 2004 Annual Report on Form 10-K, as amended, and Note 1 of this Form 10-Q, as amended.

The restatements affect disclosures and tabular amounts in Item 1, Financial Statements and Supplementary Data; Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations; and Item 4, Controls and Procedures.

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

EL PASO CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In millions, except per common share amounts)
(Unaudited)

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2004	2003 (Restated)	2004 (Restated)	2003 (Restated)
Operating revenues	$ 1,429	$ 1,714	$ 4,510	$ 5,111
Operating expenses				
Cost of products and services	390	362	1,215	1,415
Operation and maintenance	507	453	1,281	1,634
Depreciation, depletion and amortization	270	283	808	897
Loss on long-lived assets	550	54	805	463
Taxes, other than income taxes	67	81	197	229
	1,784	1,233	4,306	4,638
Operating income (loss)	(355)	481	204	473
Earnings from unconsolidated affiliates	617	79	802	31
Other income	36	49	146	132
Other expense	(21)		(57)	(129)
Interest and debt expense	(396)	(475)	(1,229)	(1,352)
Distributions on preferred interests of consolidated subsidiaries	(6)	(7)	(18)	(45)
Income (loss) before income taxes	(125)	127	(152)	(890)
Income taxes	77	62	135	(451)
Income (loss) from continuing operations	(202)	65	(287)	(439)
Discontinued operations, net of income taxes	(12)	(41)	(118)	(1,195)
Cumulative effect of accounting changes, net of income taxes				(9)
Net income (loss)	$ (214)	$ 24	$ (405)	$ (1,643)
Basic and diluted income (loss) per common share				
Income (loss) from continuing operations	$ (0.31)	$ 0.11	$ (0.45)	$ (0.74)
Discontinued operations, net of income taxes	(0.02)	(0.07)	(0.18)	(2.00)
Cumulative effect of accounting changes, net of income taxes				(0.02)
Net income (loss) per common share	$ (0.33)	$ 0.04	$ (0.63)	$ (2.76)

Basic and diluted average common shares outstanding	639	596	639	596
Dividends declared per common share	$ 0.04	$ 0.04	$ 0.12	$ 0.12

See accompanying notes.

Table of Contents

EL PASO CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In millions, except share amounts)
(Unaudited)

	September 30, 2004 (Restated)	December 31, 2003 (Restated)
ASSETS		
Current assets		
Cash and cash equivalents	$ 2,329	$ 1,429
Accounts and notes receivable		
Customers, net of allowance of $196 in 2004 and $272 in 2003	1,280	2,039
Affiliates	123	189
Other	231	245
Inventory	154	181
Assets from price risk management activities	325	706
Assets held for sale and from discontinued operations	480	2,538
Restricted cash	234	590
Deferred income taxes	563	593
Other	258	413
Total current assets	5,977	8,923
Property, plant and equipment, at cost		
Pipelines	19,175	18,563
Natural gas and oil properties, at full cost	14,884	14,689
Power facilities	1,544	1,660
Gathering and processing systems	167	334
Other	890	998
	36,660	36,244
Less accumulated depreciation, depletion and amortization	18,035	18,049
Total property, plant and equipment, net	18,625	18,195
Other assets		
Investments in unconsolidated affiliates	2,910	3,409
Assets from price risk management activities	1,555	2,338
Goodwill and other intangible assets, net	424	1,082
Other	2,162	2,996
	7,051	9,825
Total assets	$ 31,653	$ 36,943

See accompanying notes.

Table of Contents

EL PASO CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS (Continued)
(In millions, except share amounts)
(Unaudited)

	September 30, 2004 (Restated)	December 31, 2003 (Restated)
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable		
Trade	$ 938	$ 1,552
Affiliates	13	26
Other	385	438
Short-term financing obligations, including current maturities	1,554	1,457
Liabilities from price risk management activities	599	734
Western Energy Settlement	44	633
Liabilities related to assets held for sale and discontinued operations	149	933
Accrued interest	359	391
Other	787	910
Total current liabilities	4,828	7,074
Long-term financing obligations	17,673	20,275
Other		
Liabilities from price risk management activities	1,046	781
Deferred income taxes	1,580	1,558
Western Energy Settlement	342	415
Other	1,910	2,047
	4,878	4,801
Commitments and contingencies		
Securities of subsidiaries	366	447
Stockholders equity		
Common stock, par value $3 per share; authorized 1,500,000,000 shares; issued 650,956,586 shares in 2004 and 639,299,156 shares in 2003	1,952	1,917
Additional paid-in capital	4,557	4,576
Accumulated deficit	(2,267)	(1,862)
Accumulated other comprehensive income	(84)	(40)
Treasury stock (at cost); 7,522,799 shares in 2004 and 7,097,326 shares in 2003	(224)	(222)
Unamortized compensation	(26)	(23)

Total stockholders equity		3,908		4,346
Total liabilities and stockholders equity	$	31,653	$	36,943

See accompanying notes.

3

Table of Contents

EL PASO CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In millions)
(Unaudited)

	Nine Months Ended September 30,	
	2004 (Restated)(1)	2003 (Restated)(1)
Cash flows from operating activities		
Net loss	$ (405)	$ (1,643)
Less loss from discontinued operations, net of income taxes	(118)	(1,195)
Net loss before discontinued operations	(287)	(448)
Adjustments to reconcile net loss to net cash from operating activities		
Depreciation, depletion and amortization	808	897
Loss on long-lived assets	805	463
Earnings from unconsolidated affiliates, adjusted for cash distributions	(579)	224
Deferred income tax expense (benefit)	99	(482)
Cumulative effect of accounting changes		9
Other non-cash items	146	412
Asset and liability changes	(384)	633
Cash provided by continuing operations	608	1,708
Cash provided by discontinued operations	191	58
Net cash provided by operating activities	799	1,766
Cash flows from investing activities		
Additions to property, plant and equipment	(1,246)	(1,868)
Purchases of interests in equity investments	(26)	(25)
Net proceeds from the sale of assets and investments	1,758	1,382
Cash paid for acquisitions, net of cash acquired	(47)	(1,078)
Net change in restricted cash	470	(137)
Other	108	(42)
Cash provided by (used in) continuing operations	1,017	(1,768)
Cash provided by discontinued operations	1,140	297
Net cash provided by (used in) investing activities	2,157	(1,471)
Cash flows from financing activities		
Payments to retire long-term debt and other financing obligations	(1,705)	(2,091)

Net repayments under short-term debt and credit facilities		(250)
Net proceeds from the issuance of long-term debt and other financing obligations	50	3,433
Dividends paid	(75)	(178)
Payments to redeem preferred interests of consolidated subsidiaries		(1,177)
Contributions from discontinued operations	966	355
Issuances of common stock, net	73	
Other	(34)	20
Cash provided by (used in) continuing operations	(725)	112
Cash used in discontinued operations	(1,331)	(355)
Net cash used in financing activities	(2,056)	(243)
Increase in cash and cash equivalents	900	52
Cash and cash equivalents		
Beginning of period	1,429	1,591
End of period	$ 2,329	$ 1,643

(1) Only individual line items in cash flows from operating activities have been restated. Total cash flows from continuing operating, investing and financing activities, as well as discontinued operations, were unaffected.

See accompanying notes.

Table of Contents

EL PASO CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In millions)
(Unaudited)

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2004	2003 (Restated)	2004 (Restated)	2003 (Restated)
Net income (loss)	$ (214)	$ 24	$ (405)	$ (1,643)
Foreign currency translation adjustments (net of income taxes of less than $1 and $51 in 2004, and less than $1 in 2003)	3	4	(17)	120
Unrealized net gains (losses) from cash flow hedging activity				
Unrealized mark-to-market gains (losses) arising during period (net of income taxes of $33 and $45 in 2004 and $8 and $50 in 2003)	(47)	38	(70)	108
Reclassification adjustments for changes in initial value to the settlement date (net of income taxes of $3 and $18 in 2004 and less than $1 and $27 in 2003)	4	(2)	43	(61)
Other comprehensive income (loss)	(40)	40	(44)	167
Comprehensive income (loss)	$ (254)	$ 64	$ (449)	$ (1,476)

See accompanying notes.

Table of Contents

EL PASO CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation and Significant Events Update

Basis of Presentation

We prepared this Quarterly Report on Form 10-Q, as amended, under the rules and regulations of the U.S. Securities and Exchange Commission. Because this is an interim period filing presented using a condensed format, it does not include all of the disclosures required by generally accepted accounting principles. You should read this Quarterly Report on Form 10-Q along with our 2003 Annual Report on Form 10-K, which includes a summary of our significant accounting policies and other disclosures. The financial statements as of September 30, 2004, and for the quarters and nine months ended September 30, 2004 and 2003, are unaudited. We derived the balance sheet as of December 31, 2003, from the audited balance sheet filed in our 2003 Annual Report on Form 10-K. In our opinion, we have made all adjustments which are of a normal, recurring nature to fairly present our interim period results. Due to the seasonal nature of our businesses, information for interim periods may not be indicative of the results of operations for the entire year. Our results for all periods presented have been reclassified to reflect our Canadian and certain other international natural gas and oil production operations as discontinued operations. Finally, the prior period information presented in these financial statements includes reclassifications which were made to conform to the current period presentation. These reclassifications had no effect on our previously reported net income or stockholders equity.

Restatements

Overview. As disclosed in our 2004 Annual Report on Form 10-K, as amended, our 2004, 2003 and 2002 financial statements were restated for several matters. Our 2002 financial statements were restated to reflect a correction in the manner in which we adopted Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*. Our 2003 and 2004 financial statements were restated to reflect adjustments resulting from errors in the accounting and reporting for foreign currency translation adjustments (CTA) and related tax adjustments. This Form 10-Q, as amended, is being filed to reflect the effects of those restatements in our historical financial statements for the interim period ended September 30, 2004. Each restatement is further discussed below.

Cumulative Foreign Currency Translation Adjustments (CTA). During 2005, we determined that our CTA balances contained amounts related to businesses that had been previously sold or abandoned. These businesses and investments primarily included our discontinued Canadian exploration and production operations and certain of our discontinued petroleum markets activities, foreign plants in our Power segment, and certain foreign operations in our Marketing and Trading segment. The adjustment of these CTA balances also affected losses we recorded in the first quarter of 2004 on several of these assets and investments, including impairment charges.

In conjunction with the revisions for CTA, we also determined that upon initially recognizing deferred income taxes on certain of our foreign operations, we did not properly allocate taxes to CTA. As a result, we should have recognized an additional income tax expense in the first quarter of 2004 upon the sale of our discontinued Canadian exploration and production operations, and additional tax expense in the second quarter of 2004 upon the sale of an Australian.

Goodwill. During the completion of the financial statements for the year ended December 31, 2004, we identified an error in the manner in which we had originally adopted the provisions of SFAS No. 141, *Business Combinations,* and SFAS No. 142, *Goodwill and Other Intangible Assets,* in 2002. Upon adoption of these standards, we incorrectly adjusted the cost of investments in unconsolidated affiliates and the cumulative effect of change in accounting principle for the excess of our share of the affiliates fair value of net assets over

Table of Contents

their original cost, which we believed was negative goodwill. The amount originally recorded as a cumulative effect of accounting change was $154 million and related to our investments in Citrus Corporation, Portland Natural Gas, several Australian investments and an investment in the Korea Independent Energy Corporation. We subsequently determined that the amounts we adjusted were not negative goodwill, but rather amounts that should have been allocated to the long-lived assets underlying our investments. As a result, we have restated our balance sheets as of September 30, 2004 and December 31, 2003 to reflect the reversal of the amounts we recorded as a cumulative effect of an accounting change on January 1, 2002, a related deferred tax adjustment and an unrealized loss we recorded on our Australian investments during 2002. The effect of this restatement as of December 31, 2003, was to reduce investments in unconsolidated affiliates by $142 million, reduce deferred income tax liabilities by $20 million, and to increase our accumulated deficit and reduce total stockholders equity by $122 million. This restatement is further discussed in our 2004 Annual Report on Form 10-K, as amended.

Below are the effects of the restatements on our income statement, balance sheets and statement of comprehensive income as compared to amounts reported in our Form 10-Q for the nine months ended September 30, 2004 filed on December 17, 2004. We have reflected these restatements in Notes 2, 4, 6, 7, 8, 15 and 16.

	For the Nine Months Ended September 30, 2004	
	As Reported	**As Restated**
	(In millions, except per share amounts)	
Income Statement:		
Loss on long-lived assets	$ 789	$ 805
Operating income	220	204
Earnings from unconsolidated affiliates	815	802
Other income, net	139	146
Income (loss) before income taxes	(130)	(152)
Income taxes	124	135
Income (loss) from continuing operations	(254)	(287)
Discontinued operations, net of income taxes	(150)	(118)
Net income (loss)	(404)	(405)
Basic and diluted income (loss) per share:		
Loss from continuing operations	$ (0.40)	$ (0.45)
Discontinued operations, net of income taxes	(0.23)	(0.18)
Net income (loss)	$ (0.63)	$ (0.63)
Statement of Comprehensive Income		
Foreign currency translation adjustments	$ (22)	$ (17)
Other comprehensive income	(49)	(44)

	As of September 30, 2004		**As of December 31, 2003**	
	As Reported	**As Restated**	**As Reported**	**As Restated**

Balance Sheet:				
Deferred income tax assets	$ 563	$ 563	$ 592	$ 593
Property, plant and equipment Power facilities	1,528	1,544	1,660	1,660
Accumulated depreciation, depletion and amortization	18,019	18,035	18,049	18,049
Investments in unconsolidated affiliates	3,052	2,910	3,551	3,409
Deferred income tax liabilities, non-current	1,598	1,580	1,571	1,558
Accumulated deficit	(2,189)	(2,267)	(1,785)	(1,862)
Accumulated other comprehensive income	(38)	(84)	11	(40)
Total stockholders equity	4,032	3,908	4,474	4,346

Reserve Revisions and Accounting for Certain Derivatives. Our results of operations for the quarter and nine months ended September 30, 2003 have also been restated to reflect the accounting impact of a reduction in our historically reported proved natural gas and oil reserves and to revise the manner in which we accounted for certain hedges, primarily those associated with our anticipated natural gas and oil production. These restatements are further discussed in our 2003 Annual Report on Form 10-K.

Business Update

In December 2003, our management presented its Long-Range Plan for the company. This plan, among other things, defined our core businesses, established a timeline for debt reductions and sales of non-core businesses and assets and set financial goals for the future. During 2004, and through the filing date of this Form 10-Q, we have made significant progress in the areas outlined in that plan, including:

- completing or announcing sales of assets and investments of approximately $3.3 billion (see Note 4);

- retiring, eliminating, or refinancing approximately $4.2 billion of debt and other obligations ($2.6 billion through September 30, 2004) (see Note 11);

- finalizing the Western Energy Settlement, which substantially resolved our principal exposure relating to the western energy crisis and successfully raising funds to satisfy a significant portion of our current obligations under that settlement (see Note 12); and

- entering into a new credit agreement in November 2004 to refinance our previous revolving credit facility with an aggregate of $3 billion in financings consisting of a $1.25 billion, five-year term loan; a $1.0 billion, three-year revolving credit facility; and a $750 million, five-year funded letter of credit facility (see Note 11).

Liquidity Update

During 2004, we received waivers and amendments to our then existing revolving credit facility and various other financing arrangements to address events that we believe would have constituted an event of default; specifically under the provisions in those arrangements related to the timely filing of our financial statements, representations and warranties on the accuracy of our historical financial statements and on our debt to total capitalization ratio. We have filed our financial statements within the time frames granted by these waivers.

In November 2004, we replaced our previous revolving credit facility which was scheduled to mature in June 2005, with a new credit agreement with a group of lenders for an aggregate of $3 billion in financings. The new credit agreement consists of a $1.25 billion, five-year term loan; a $1 billion, three-year revolving credit facility under which we can issue letters of credit; and an additional $750 million, five-year funded letter of credit facility. The letter of credit facility provides us the ability to issue letters of credit or borrow any unused capacity as term loans. The new credit agreement is collateralized by our interests in El Paso Natural Gas Company (EPNG), Tennessee Gas Pipeline Company (TGP), ANR Pipeline Company (ANR), Colorado Interstate Gas Company (CIG), Wyoming Interstate Company Ltd. (WIC), ANR Storage Company and Southern Gas Storage Company.

Our new credit agreement provided approximately $220 million in net additional borrowing availability (after repayment of an existing obligation of approximately $229 million and various other items) as compared to our previous revolving credit facility. Upon closing of the new credit agreement, we borrowed $1.25 billion under the term loan and utilized the $750 million letter of credit facility and approximately $0.4 billion of the $1 billion revolving credit facility to replace approximately $1.2 billion of letters of credit issued under our previous revolving credit facility.

El Paso CGP Company, our subsidiary, has not yet filed its financial statements for the third quarter of 2004, as required under several of its, and its affiliates , financing arrangements. We believe El Paso CGP s financial statements will be filed prior to any notice being given or within the allowed time frames under those arrangements such that there will be no event of default.

Table of Contents

2. Significant Accounting Policies

Our significant accounting policies are discussed in our 2003 Annual Report on Form 10-K. The information below provides updating information or required interim disclosures with respect to those policies or disclosure where our policies have changed.

Stock-Based Compensation

We account for our stock-based compensation plans using the intrinsic value method under the provisions of Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees,* and its related interpretations. Had we accounted for our stock option grants using Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation,* rather than APB No. 25, the loss and per share impacts of stock-based compensation on our financial statements would have been different. The following table shows the impact on net income (loss) and income (loss) per share had we applied SFAS No. 123:

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004 (Restated)	2003
	(In millions)			
Net income (loss) as reported	$ (214)	$ 24	$ (405)	$ (1,643)
Add: Stock-based compensation expense in net income (loss), net of taxes	4	8	11	35
Deduct: Stock-based compensation expense determined under fair value-based method for all awards, net of taxes	9	21	28	73
Pro forma net income (loss)	$ (219)	$ 11	$ (422)	$ (1,681)
Income (loss) per share:				
Basic and diluted, as reported	$ (0.33)	$ 0.04	$ (0.63)	$ (2.76)
Basic and diluted, pro forma	$ (0.34)	$ 0.02	$ (0.66)	$ (2.82)

Consolidation of Variable Interest Entities

In January 2003, the FASB issued Financial Interpretation (FIN) No. 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51.* This interpretation defines a variable interest entity as a legal entity whose equity owners do not have sufficient equity at risk or a controlling financial interest in the entity. This standard requires a company to consolidate a variable interest entity if it is allocated a majority of the entity s losses or returns, including fees paid by the entity. In December 2003, the FASB issued FIN No. 46-R, which amended FIN No. 46 to extend its effective date until the first quarter of 2004 for all types of entities, except special purpose entities. In addition, FIN No. 46-R limited the scope of FIN No. 46 to exclude certain joint ventures or other entities that meet the characteristics of businesses.

On January 1, 2004, we adopted this standard. Upon adoption, we consolidated Blue Lake Gas Storage Company and several other minor entities and deconsolidated a previously consolidated entity, EMA Power Kft. The overall impact of these actions is described in the following table:

	Increase/(Decrease)
	(In millions)
Restricted cash	$ 34
Accounts and notes receivable from affiliates	(54)
Investments in unconsolidated affiliates	(5)
Property, plant, and equipment, net	37
Other current and non-current assets	(15)
Long-term financing obligations	15
Other current and non-current liabilities	(4)
Minority interest of consolidated subsidiaries	(14)

Blue Lake Gas Storage owns and operates a 47 Bcf gas storage facility in Michigan. One of our subsidiaries operates the natural gas storage facility and we inject and withdraw all natural gas stored in the facility. We own a 75 percent equity interest in Blue Lake. This entity has $9 million of third party debt as of September 30, 2004 that is non-recourse to us. We consolidated Blue Lake because we are allocated a majority of Blue Lake s losses and returns through our equity interest in Blue Lake.

EMA Power Kft owns and operates a 69 gross MW dual-fuel-fired power facility located in Hungary. We own a 50 percent equity interest in EMA. Our equity partner has a 50 percent interest in EMA, supplies all of the fuel consumed and purchases all of the power generated by the facility. Our exposure to this entity is limited to our equity interest in EMA, which was approximately $33 million as of September 30, 2004. We deconsolidated EMA because our equity partner is allocated a majority of EMA s losses and returns through its equity interest and its fuel supply and power purchase agreements with EMA.

We have significant interests in a number of other variable interest entities. We were not required to consolidate these entities under FIN No. 46 and, as a result, our method of accounting for these entities did not change. As of September 30, 2004, these entities consisted primarily of 21 equity investments held in our Power segment that had interests in power generation and transmission facilities with a total generating capacity of approximately 7,800 gross MW. We operate many of these facilities but do not supply a significant portion of the fuel consumed or purchase a significant portion of the power generated by these facilities. The long-term debt issued by these entities is recourse only to the power project. As a result, our exposure to these entities is limited to our equity investments in and advances to the entities ($1.6 billion as of September 30, 2004) and our guarantees and other agreements associated with these entities (a maximum of $104 million as of September 30, 2004).

During our adoption of FIN No. 46, we attempted to obtain financial information on several potential variable interest entities but were unable to obtain that information. The most significant of these entities is the Cordova power project which is the counterparty to our largest tolling arrangement. Under this tolling arrangement, we supply on average a total of 54,000 MMBtu of natural gas per day to the entity s two 250 gross MW power facilities and are obligated to market the power generated by those facilities through 2019. In addition, we pay that entity a capacity charge that ranges from $25 million to $30 million per year related to its power plants. The following is a summary of the financial statement impacts of our transactions with this entity for the nine months ended September 30, 2004 and 2003, and as of September 30, 2004 and December 31, 2003:

	2004	2003
	(In millions)	
Operating revenues	$ (30)	$ 26

Current liabilities from price risk management activities	(19)	(28)
Non-current liabilities from price risk management activities	(30)	(6)

10

Table of Contents

Accounting for Asset Retirement Obligations

On January 1, 2003, we adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*. This standard required that we record a liability for retirement and removal costs of long-lived assets used in our businesses. In 2003, we recorded a charge as a cumulative effect of an accounting change of approximately $9 million, net of income taxes related to its adoption.

Goodwill and Other Intangible Assets

Our intangible assets consist of goodwill resulting from acquisitions and other intangible assets. The net carrying amounts of our goodwill as of September 30, 2004, and the changes in the net carrying amounts of goodwill for the nine months ended September 30, 2004, for each of our segments are as follows:

	Pipelines	Field Services	Corporate	Total
		(In millions)		
Balances as of January 1, 2004	$ 413	$ 480	$ 3	$ 896
Impairments of goodwill		(480)		(480)
Other changes			(3)	(3)
Balances as of September 30, 2004	$ 413	$	$	$ 413

In September 2004, we completed the sale of substantially all of our interests in GulfTerra Energy Partners (GulfTerra), as well as certain processing assets in our Field Services segment, to affiliates of Enterprise Products Partners, L.P. (Enterprise). As a result of these sales, we determined that the remaining assets in our Field Services segment could not support the goodwill in this segment, and therefore, we fully impaired this amount in the third quarter of 2004. See Note 16 for a further discussion of the impact of the Enterprise transactions on our goodwill and other intangible assets during the third quarter of 2004.

New Accounting Pronouncements Not Yet Adopted

Accounting for Natural Gas and Oil Producing Activities. In September 2004, the SEC issued Staff Accounting Bulletin No. 106. This pronouncement will require companies that use the full cost method for accounting for their oil and gas producing activities to include an estimate of future asset retirement costs to be incurred as a result of future development activities on proved reserves in their calculation of depreciation, depletion and amortization. It will also require these companies to exclude future cash outflows associated with settling asset retirement liabilities from their full cost ceiling test calculation. Finally, this standard will require disclosure of the impact of a company s asset retirement obligations on its oil and gas producing activities, ceiling test calculations and depreciation, depletion and amortization calculations. We will adopt the provisions of this pronouncement in the first quarter of 2005 and are currently evaluating its impact, if any, on our consolidated financial statements.

Accounting for Inventory Costs. In November 2004, the FASB issued SFAS No. 151, *Inventory Costs, an amendment of ARB No. 43, Chapter 4.* This statement clarifies the types of costs that should be expensed rather than capitalized as inventory. This statement also clarifies the circumstances under which fixed overhead costs associated with operating facilities involved in inventory processing should be capitalized. The provisions of SFAS No. 151 are effective for fiscal years beginning after June 15, 2005, and may impact certain inventory costs we incur after January 1, 2006. We are currently evaluating the impact, if any, of this standard on our consolidated financial statements.

Accounting for Stock-Based Compensation. In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment: an amendment of SFAS No. 123 and 95.* This standard requires that companies record the fair value of their stock-based compensation arrangements as a liability or as a component of equity on the date they are granted to employees. The classification of these arrangements as liabilities or as a component of equity is based on whether the obligations can be settled in cash and/or in stock. Regardless of their treatment as liabilities or equity, these amounts are to be expensed over the vesting period of the arrangements. This

11

Table of Contents

standard is effective for interim periods beginning after June 15, 2005, at which time companies can select whether they will apply the standard retroactively by restating their historical financial statements or prospectively for new stock-based compensation arrangements and the unvested portion of existing arrangements. We will adopt this pronouncement in the third quarter of 2005 and are currently evaluating its impact on our consolidated financial statements.

Accounting for Deferred Taxes on Foreign Earnings. In December 2004, the FASB is expected to issue FASB Staff Position (FSP) No. 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*. FSP No. 109-2 will clarify the existing accounting literature that requires companies to record deferred taxes on foreign earnings, unless they intend to indefinitely reinvest those earnings outside the U.S. This pronouncement will temporarily allow companies that are evaluating whether to repatriate foreign earnings under the American Jobs Creation Act of 2004 to delay recognizing any related taxes until that decision is made. This pronouncement will also require companies that are considering repatriating earnings to disclose the status of their evaluation and the potential amounts being considered for repatriation. The U.S. Treasury Department has not issued final guidelines for applying the repatriation provisions of the American Jobs Creation Act, and we continue to evaluate this legislation and FSP No. 109-2 to determine whether we will repatriate any foreign earnings and the impact, if any, that this pronouncement will have on our financial statements.

3. Acquisitions and Consolidations

Chaparral Investors, L.L.C. As discussed more completely in our 2003 Annual Report on Form 10-K, we acquired Chaparral in a series of transactions (also referred to as a step acquisition). We reflected Chaparral s results of operations in our income statement as though we acquired it on January 1, 2003. Although this did not change our reported net income for the first quarter of 2003, it did impact the individual components of our income statement by increasing our revenues by $76 million, operating expenses by $80 million, earnings (losses) from unconsolidated affiliates by $55 million, interest expense by $67 million and decreasing distributions on preferred interests in subsidiaries by $18 million and other income by $2 million.

During the first quarter of 2003, as a result of an additional investment in Limestone Electron Trust (Limestone), coupled with a number of developments including a general decline in power prices, declines in our credit ratings as well as those of our counterparties, adverse developments at several of Chaparral s projects, our announced exit from the power contract restructuring business and generally weaker economic conditions in the unregulated power industry, we determined that the fair value of Chaparral (based on its discounted expected net cash flows) was less than our carrying value of the investment. As a result, we recorded an impairment of $207 million on Chaparral, before income taxes, during the first quarter of 2003.

Gemstone. As discussed more completely in our 2003 Annual Report on Form 10-K, we acquired all of the outstanding third party interests in Gemstone for approximately $50 million in April 2003. The results of Gemstone s operations have been included in our consolidated financial statements beginning April 1, 2003. Had the acquisition been effective January 1, 2003, our revenues, operating income, and net income for the quarter ended March 31, 2003 would not have been significantly different, and basic and diluted earnings per share would have been unaffected.

Table of Contents

4. Divestitures

Sales of Assets and Investments

During 2004, we completed and announced the sale of a number of assets and investments in each of our business segments. The following table summarizes the proceeds from these sales:

Significant Assets and Investments Sold	**Completed Through September 30, 2004**	**Completed After September 30, 2004 or Announced to Date[(1)]**	**Total**
		(In millions)	
Regulated			
Pipelines	$ 54	$	$ 54
Australia pipelines			
Aircraft			
Interest in gathering systems			
Unregulated			
Production	24		24
Brazilian exploration and production assets			
Power	699	184	883
Utility Contract Funding (UCF)[(2)]			
Mohawk River Funding IV[(2)]			
Bastrop Company equity investment[(2)]			
25 domestic power plants under contract[(3)]			
5 other domestic power plants and turbines[(2)]			
Field Services	1,029		1,029
General partnership interest, common units and Series C units of GulfTerra			
South Texas processing plants			
Dauphin Island and Mobile Bay equity investments			
Other			
Corporate	16		16
Aircraft			
Total continuing	1,822[(4)]	184	2,006

Discontinued		1,293		2		1,295
Natural gas and oil production properties in Canada and other international production assets[2]						
Aruba and Eagle Point refineries and other petroleum assets[2]						
Total	$	3,115	$	186	$	3,301

(1) Sales that have not been completed are estimates, subject to customary regulatory approvals, final negotiations and other conditions.

(2) These sales were completed as of September 30, 2004.

(3) The sales of 21 of these plants were completed as of September 30, 2004, and three additional sales were completed in the fourth quarter of 2004.

(4) Proceeds exclude returns of invested capital and cash transferred with the assets sold and include costs incurred in preparing assets for disposal. These items decreased our sales proceeds by $64 million for the nine months ended September 30, 2004. Proceeds also exclude any non-cash consideration received in these sales.

Table of Contents

Significant Assets and Investments Sold	Proceeds (In millions)
Through September 30, 2003	
Regulated	
Pipelines	$ 82
Panhandle gathering system located in Texas	
2.1 percent interest in Alliance pipeline and related assets	
Helium processing operations in Oklahoma	
Table Rock sulfur extraction facility	
Horsham pipeline in Australia	
Unregulated	
Production	678
Natural gas and oil properties in New Mexico, Texas, Louisiana, Oklahoma and the Gulf of Mexico	
Drilling rigs	
Power	300
50 percent interest in CE Generation L.L.C. power investment	
Mt. Carmel power plant	
Interest in Kladno power project	
CAPSA/CAPEX investments in Argentina	
Mohawk River Funding I, L.L.C.	
Field Services	153
Gathering systems located in Wyoming	
Midstream assets in the north Louisiana and Mid-Continent regions	
Other	
Corporate	113
Aircraft	
Enerplus Global Energy Management Company and its financial operations	
Encap funds management business and related investments	