

EL PASO NATURAL GAS CO

Form 10-Q

November 06, 2006

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

Form 10-Q

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2006

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 1-2700

El Paso Natural Gas Company
(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or Other Jurisdiction
of Incorporation or Organization)

74-0608280
(I.R.S. Employer
Identification No.)

El Paso Building
1001 Louisiana Street
Houston, Texas
(Address of Principal Executive Offices)

77002
(Zip Code)

Telephone Number: (713) 420-2600

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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 No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

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 \$1 per share. Shares outstanding on November 3, 2006: 1,000

EL PASO NATURAL GAS COMPANY MEETS THE CONDITIONS OF GENERAL INSTRUCTION H(1)(a) AND (b) TO FORM 10-Q AND IS THEREFORE FILING THIS REPORT WITH A REDUCED DISCLOSURE FORMAT AS PERMITTED BY SUCH INSTRUCTION.

EL PASO NATURAL GAS COMPANY

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* We have not included a response to this item in this document since no response is required pursuant to the reduced disclosure format permitted by General Instruction H to Form 10-Q.

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

/d = per day

BBtu = billion British thermal units

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 EPNG , we are describing El Paso Natural Gas Company and/or our subsidiaries.

Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****EL PASO NATURAL GAS COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(In millions)****(Unaudited)**

	Quarters Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Operating revenues	\$ 155	\$ 125	\$ 450	\$ 371
Operating expenses				
Operation and maintenance	44	79	141	168
Depreciation, depletion and amortization	23	19	71	56
Taxes, other than income taxes	8	8	24	24
	75	106	236	248
Operating income	80	19	214	123
Other income, net		2	3	6
Interest and debt expense	(24)	(23)	(71)	(69)
Affiliated interest income, net	15	9	40	22
Income before income taxes	71	7	186	82
Income taxes	26	2	70	31
Net income	\$ 45	\$ 5	\$ 116	\$ 51

See accompanying notes.

Table of Contents**EL PASO NATURAL GAS COMPANY****CONDENSED CONSOLIDATED BALANCE SHEETS****(In millions, except share amounts)
(Unaudited)**

	September 30, 2006	December 31, 2005
ASSETS		
Current assets		
Cash and cash equivalents	\$	\$
Accounts and notes receivable		
Customer, net of allowance of \$5 in 2006 and \$18 in 2005	112	114
Affiliates	4	4
Materials and supplies	40	41
Deferred income taxes	23	14
Restricted cash	3	17
Other	5	3
Total current assets	187	193
Property, plant and equipment, at cost	3,521	3,417
Less accumulated depreciation, depletion and amortization	1,250	1,193
Total property, plant and equipment, net	2,271	2,224
Other assets		
Notes receivable from affiliate	1,010	872
Other	86	89
	1,096	961
Total assets	\$ 3,554	\$ 3,378
LIABILITIES AND STOCKHOLDER S EQUITY		
Current liabilities		
Accounts payable		
Trade	\$ 47	\$ 84
Affiliates	13	6
Other	4	17
Taxes payable	95	27
Accrued interest	23	25
Accrued liabilities	61	50
Other	16	12
Total current liabilities	259	221

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Long-term debt	1,111	1,110
Other liabilities		
Deferred income taxes	394	364
Other	96	105
	490	469
Commitments and contingencies		
Stockholder's equity		
Common stock, par value \$1 per share; 1,000 shares authorized, issued and outstanding		
Additional paid-in capital	1,268	1,268
Retained earnings	426	310
Total stockholder's equity	1,694	1,578
Total liabilities and stockholder's equity	\$ 3,554	\$ 3,378

See accompanying notes.

Table of Contents**EL PASO NATURAL GAS COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In millions)****(Unaudited)**

	Nine Months Ended	
	September 30,	
	2006	2005
Cash flows from operating activities		
Net income	\$ 116	\$ 51
Adjustments to reconcile net income to net cash from operating activities		
Depreciation, depletion and amortization	71	56
Deferred income taxes	21	7
Other non-cash income items	(3)	(2)
Asset and liabilities changes	21	58
Net cash provided by operating activities	226	170
Cash flows from investing activities		
Additions to property, plant and equipment	(102)	(80)
Net change in notes receivable from affiliate	(138)	(93)
Net change in restricted cash	14	
Other		2
Net cash used in investing activities	(226)	(171)
Net change in cash and cash equivalents		(1)
Cash and cash equivalents		
Beginning of period		1
End of period	\$	\$

See accompanying notes.

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EL PASO NATURAL GAS COMPANY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation and Significant Accounting Policies

Basis of Presentation

We are an indirect wholly owned subsidiary of El Paso Corporation (El Paso). We prepared this Quarterly Report on Form 10-Q under the rules and regulations of the United States Securities and Exchange Commission (SEC). 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 in the United States of America. You should read this Quarterly Report on Form 10-Q along with our 2005 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, 2006, and for the quarters and nine months ended September 30, 2006 and 2005, are unaudited. We derived the balance sheet as of December 31, 2005, from the audited balance sheet filed in our 2005 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 business, information for interim periods may not be indicative of our results of operations for the entire year.

Significant Accounting Policies

Our significant accounting policies are consistent with those discussed in our 2005 Annual Report on Form 10-K. The information below provides updating information with respect to those policies.

Accounting for Pipeline Integrity Costs. In December 2005, we adopted an accounting release issued by the Federal Energy Regulatory Commission (FERC) that required us to prospectively expense certain costs we incur related to our pipeline integrity program. Prior to adoption, we capitalized these costs as part of our property, plant and equipment. During the quarter and nine months ended September 30, 2006, we expensed approximately \$1 million and \$3 million as a result of the adoption of this accounting release. We anticipate we will expense additional costs of approximately \$2 million for the remainder of the year.

New Accounting Pronouncements Issued But Not Yet Adopted

Accounting for Uncertainty in Income Taxes. In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*. FIN No. 48 clarifies Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*, and requires us to evaluate our tax positions for all jurisdictions and all years where the statute of limitations has not expired. FIN No. 48 requires companies to meet a more-likely-than-not threshold (i.e. greater than a 50 percent likelihood of a tax position being sustained under examination) prior to recording a benefit for their tax positions. Additionally, for tax positions meeting this more-likely-than-not threshold, the amount of benefit is limited to the largest benefit that has a greater than 50 percent probability of being realized upon ultimate settlement. The cumulative effect of applying the provisions of the new interpretation, if any, will be recorded as an adjustment to the beginning balance of retained earnings, or other components of stockholder's equity as appropriate, in the period of adoption. We will adopt the provisions of this interpretation effective January 1, 2007, and are currently evaluating the impact that this interpretation will have on our financial statements.

Fair Value Measurements. In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which provides guidance on measuring the fair value of assets and liabilities in the financial statements. We will be required to adopt the provisions of this standard no later than in 2008, and are currently evaluating the impact, if any, that this will have on our financial statements.

Accounting for Pension and Other Postretirement Benefits. In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - An Amendment of FASB Statements No. 87, 88, 106, and 132(R)*. SFAS No. 158 requires companies to record an asset or liability for their pension and other postretirement benefit plans based on their funded or unfunded status.

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The standard also requires any deferred amounts related to unrealized gains and losses or changes in actuarial assumptions to be recorded in accumulated other comprehensive income, a component of stockholder's equity, until those gains and losses are realized. Finally, the standard requires companies to measure their pension and postretirement obligations as of their year end balance sheet date beginning in 2008.

We will adopt the provisions of this standard effective December 31, 2006, and currently do not anticipate that it will have a material impact on our financial statements. SFAS No. 158 will also require us to change the measurement date for our other postretirement benefit plans from September 30, the date we currently use, to December 31 beginning in 2008.

Evaluation of Prior Period Misstatements in Current Financial Statements. In September 2006, the staff of the SEC released Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements*. SAB No. 108 provides guidance on how to evaluate the impact of financial statement misstatements from prior periods that have been identified in the current year. We will adopt the provisions of SAB No. 108 in the fourth quarter of 2006, and do not anticipate that it will have a material impact on our financial statements.

2. Credit Facilities

In July 2006, El Paso restructured its \$3 billion credit agreement. As part of this restructuring, El Paso entered into a new \$1.75 billion credit agreement, consisting of a \$1.25 billion three-year revolving credit facility and a \$500 million five-year deposit letter of credit facility. We continue to be an eligible borrower under the new \$1.75 billion credit agreement and are only liable for amounts we directly borrow. We had no borrowings at September 30, 2006 under the agreement. Our common stock and the common stock of several of our affiliates are pledged as collateral under the agreement, however, our interest in Mojave Pipeline Company is no longer directly pledged. At September 30, 2006, there was approximately \$0.7 billion of borrowing capacity available under the \$1.75 billion credit agreement.

3. Commitments and Contingencies

Legal Proceedings

Sierra Pacific Resources and Nevada Power Company v. El Paso et al. In April 2003, Sierra Pacific Resources and Nevada Power Company filed a suit in the U.S. District Court for the District of Nevada against us, our affiliates and unrelated third parties, alleging that the defendants conspired to manipulate prices and supplies of natural gas in the California-Arizona border market from 1996 to 2001. In January 2004, the court dismissed the lawsuit. The plaintiffs subsequently amended the complaint, which was dismissed again in late 2004. The plaintiffs have appealed that dismissal to the U.S. Court of Appeals for the Ninth Circuit. The appeal has been fully briefed. Our costs and legal exposure related to this lawsuit are not currently determinable.

Phelps Dodge v. EPNG. In February 2004, one of our customers, Phelps Dodge, and a number of its affiliates filed a lawsuit against us in the state court of Arizona. The plaintiffs claim we violated Arizona anti-trust statutes and allege that during 2000-2001, we unlawfully withheld capacity and thereby manipulated and inflated gas prices. The case was dismissed by the Maricopa County Superior Court in August 2005, and the dismissal was upheld by the Court of Appeals. The time for appealing to the Arizona Supreme Court has expired.

Carlsbad. In August 2000, a main transmission line owned and operated by us ruptured at the crossing of the Pecos River near Carlsbad, New Mexico. Twelve individuals at the site were fatally injured. In June 2001, the U.S. Department of Transportation's (DOT) Office of Pipeline Safety issued a Notice of Probable Violation and Proposed Civil Penalty to us. The Notice alleged violations of DOT regulations, proposed fines totaling \$2.5 million

and proposed corrective actions. In April 2003, the National Transportation Safety Board issued its final report on the rupture, finding that the rupture was probably caused by internal corrosion that was not detected by our corrosion control program. In December 2003, this matter was referred by the DOT to the Department of Justice (DOJ). As a result of the referral to the DOJ, the amount of the proposed fine may increase substantially from the DOT's proposed fine of \$2.5 million and may also involve implementation of additional operational and safety measures. Negotiations with the DOJ are continuing.

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In addition, a lawsuit entitled Baldonado et al. v. EPNG was filed in June 2003, in state court in Eddy County, New Mexico, on behalf of 23 firemen and emergency medical service personnel who responded to the fire and who allegedly have suffered psychological trauma. This case was dismissed by the trial court, but was appealed to the New Mexico Court of Appeals. In June 2006, the New Mexico Court of Appeals affirmed the dismissal of the plaintiff's claims for negligent infliction of emotional distress but reversed the dismissal of the claims for intentional infliction of emotional distress. The New Mexico Supreme Court has agreed to review the actions by the Court of Appeals. Our costs and legal exposure related to the *Baldonado* lawsuit are currently not determinable, however, we believe these matters will be fully covered by insurance. All other personal injury suits related to the rupture have been settled.

Gas Measurement Cases. We and a number of our affiliates were named defendants in actions that generally allege mismeasurement of natural gas volumes and/or heating content resulting in the underpayment of royalties. The first set of cases was filed in 1997 by an individual under the False Claims Act, which has been consolidated for pretrial purposes (*In re: Natural Gas Royalties Qui Tam Litigation*, U.S. District Court for the District of Wyoming). These complaints allege an industry-wide conspiracy to underreport the heating value as well as the volumes of the natural gas produced from federal and Native American lands. In May 2005, a representative appointed by the court issued a recommendation to dismiss most of the actions. In October 2006, the U.S. District Judge issued an order dismissing all measurement claims against all defendants.

Similar allegations were filed in a second action in 1999 in *Will Price, et al. v. Gas Pipelines and Their Predecessors, et al.*, in the District Court of Stevens County, Kansas. The plaintiffs currently seek certification of a class of royalty owners in wells on non-federal and non-Native American lands in Kansas, Wyoming and Colorado. Motions for class certification have been briefed and argued in the proceedings and the parties are awaiting the court's ruling. The plaintiffs seek an unspecified amount of monetary damages in the form of additional royalty payments (along with interest, expenses and punitive damages) and injunctive relief with regard to future gas measurement practices. Our costs and legal exposure related to this lawsuit and claim are not currently determinable.

Bank of America. We were a named defendant, along with Burlington Resources, Inc. (Burlington), in two class action lawsuits styled *Bank of America, et al. v. El Paso Natural Gas Company, et al.*, and *Deane W. Moore, et al. v. Burlington Northern, Inc., et al.*, each filed in 1997 in the District Court of Washita County, Oklahoma and subsequently consolidated by the court. The consolidated class action has been settled. Our settlement contribution was approximately \$30 million plus interest, which was fully accrued and paid on August 1, 2006. A third action, styled *Bank of America, et al. v. El Paso Natural Gas and Burlington Resources Oil and Gas Company, L.P.*, was filed in October 2003 in the District Court of Kiowa County, Oklahoma asserting similar claims as to specified shallow wells in Oklahoma, Texas and New Mexico. All the claims in this action have also been settled subject to court approval, after a fairness hearing scheduled for March 2007. We filed an action styled *El Paso Natural Gas Company v. Burlington Resources, Inc. and Burlington Resources Oil and Gas Company, L.P.* against Burlington in state court in Harris County, Texas relating to the indemnity issues between Burlington and us. That action was stayed by agreement of the parties and settled in November 2005, subject to all the underlying class settlements being finalized and approved by the court.

In addition to the above matters, we and our subsidiaries and affiliates are also named defendants in numerous lawsuits and governmental proceedings that arise in the ordinary course of our business.

For each of our outstanding legal matters, we evaluate the merits of the case, our exposure to the matter, possible legal or settlement strategies and the likelihood of an unfavorable outcome. If we determine that an unfavorable outcome is probable and can be estimated, we establish the necessary accruals. As further information becomes available, or other relevant developments occur, we adjust our accrual amounts accordingly. While there are still uncertainties related to the ultimate costs we may incur, based upon our evaluation and experience to date, we believe our current reserves are adequate. At September 30, 2006, we had accrued approximately \$15 million for our outstanding legal matters.

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We are subject to federal, state and local laws and regulations governing environmental quality and pollution control. These laws and regulations require us to remove or remedy the effect on the environment of the disposal or release of specified substances at current and former operating sites. At September 30, 2006, we had accrued approximately \$28 million for expected remediation costs and associated onsite, offsite and groundwater technical studies and for related environmental legal costs. This accrual includes \$23 million for environmental contingencies related to properties we previously owned. Our accrual represents a combination of two estimation methodologies. First, where the most likely outcome can be reasonably estimated, that cost has been accrued. Second, where the most likely outcome cannot be estimated, a range of costs is established and if no one amount in that range is more likely than any other, the lower end of the expected range has been accrued. Our exposure could be as high as \$50 million. Our environmental remediation projects are in various stages of completion. The liabilities we have recorded reflect our current estimates of amounts we will expend to remediate these sites. However, depending on the stage of completion or assessment, the ultimate extent of contamination or remediation required may not be known. As additional assessments occur or remediation efforts continue, we may incur additional liabilities.

Below is a reconciliation of our accrued liability from January 1, 2006 to September 30, 2006 (in millions):

Balance at January 1, 2006	\$ 29
Additions/adjustments for remediation activities	3
Payments for remediation activities	(4)
Balance at September 30, 2006	\$ 28

For the remainder of 2006, we estimate that our total remediation expenditures will be approximately \$1 million, which will be expended under government directed clean-up plans.

CERCLA Matters. We have received notice that we could be designated, or have been asked for information to determine whether we could be designated, as a Potentially Responsible Party (PRP) with respect to five active sites under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) or state equivalents. We have sought to resolve our liability as a PRP at these sites through ind