EL PASO CORP/DE
Form 10-Q
August 08, 2008

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

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2008

OR

o **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 *(State or Other Jurisdiction of Incorporation or Organization)*	**76-0568816** *(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

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 þ No o

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

Large accelerated filer þ Accelerated filer o Non-accelerated filer o (Do not check if a smaller reporting company) Smaller reporting company 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 August 4, 2008: 701,202,029

EL PASO CORPORATION
TABLE OF CONTENTS

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

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

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. 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 , the company or El Paso , we are describing El Paso Corporation and/or subsidiaries.

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)

	Quarters Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Operating revenues	$ 1,153	$ 1,198	$ 2,422	$ 2,220
Operating expenses				
Cost of products and services	71	60	127	115
Operation and maintenance	282	329	553	630
Depreciation, depletion and amortization	298	286	611	557
Taxes, other than income taxes	81	72	160	132
	732	747	1,451	1,434
Operating income	421	451	971	786
Earnings from unconsolidated affiliates	52	44	89	81
Loss on debt extinguishment		(86)		(287)
Other income, net	33	60	55	106
Minority interest	(7)	1	(16)	
Interest and debt expense	(221)	(231)	(454)	(514)
Income before income taxes from continuing operations	278	239	645	172
Income taxes	87	70	235	51
Income from continuing operations	191	169	410	121
Discontinued operations, net of income taxes		(3)		674
Net income	191	166	410	795
Preferred stock dividends		10	19	19
Net income available to common stockholders	$ 191	$ 156	$ 391	$ 776
Basic earnings per common share				
Income from continuing operations	$ 0.27	$ 0.23	$ 0.56	$ 0.15
Discontinued operations, net of income taxes				0.97
Net income per common share	$ 0.27	$ 0.23	$ 0.56	$ 1.12
Diluted earnings per common share				

Income from continuing operations	$ 0.25	$ 0.22	$ 0.54	$ 0.15
Discontinued operations, net of income taxes				0.96
Net income per common share	$ 0.25	$ 0.22	$ 0.54	$ 1.11
Dividends declared per common share	$	$ 0.04	$ 0.08	$ 0.08

See accompanying notes.

Table of Contents

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

	June 30, 2008	December 31, 2007
ASSETS		
Current assets		
Cash and cash equivalents	$ 274	$ 285
Accounts and notes receivable		
Customers, net of allowance of $11 in 2008 and $17 in 2007	829	468
Affiliates	145	196
Other	175	201
Inventory	143	131
Assets from price risk management activities	182	113
Deferred income taxes	458	191
Other	168	127
Total current assets	2,374	1,712
Property, plant and equipment, at cost		
Pipelines	17,191	16,750
Natural gas and oil properties, at full cost	19,011	19,048
Other	306	530
	36,508	36,328
Less accumulated depreciation, depletion and amortization	17,340	16,974
Total property, plant and equipment, net	19,168	19,354
Other assets		
Investments in unconsolidated affiliates	1,863	1,614
Assets from price risk management activities	207	302
Other	1,614	1,597
	3,684	3,513
Total assets	$ 25,226	$ 24,579

See accompanying notes.

Table of Contents

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

LIABILITIES AND STOCKHOLDERS EQUITY	June 30, 2008	December 31, 2007
Current liabilities		
Accounts payable		
Trade	$ 639	$ 460
Affiliates	9	5
Other	477	502
Current maturities of long-term financing obligations	1,236	331
Liabilities from price risk management activities	785	267
Accrued interest	182	195
Other	739	653
Total current liabilities	4,067	2,413
Long-term financing obligations, less current maturities	11,223	12,483
Other		
Liabilities from price risk management activities	1,064	931
Deferred income taxes	1,437	1,157
Other	1,566	1,750
	4,067	3,838
Commitments and contingencies (Note 8)		
Minority interest	545	565
Stockholders equity		
Preferred stock, par value $0.01 per share; authorized 50,000,000 shares; issued 750,000 shares of 4.99% convertible perpetual stock; stated at liquidation value	750	750
Common stock, par value $3 per share; authorized 1,500,000,000 shares; issued 711,992,983 shares in 2008 and 709,192,605 shares in 2007	2,136	2,128
Additional paid-in capital	4,679	4,699
Accumulated deficit	(1,420)	(1,834)
Accumulated other comprehensive loss	(617)	(272)
Treasury stock (at cost); 9,378,210 shares in 2008 and 8,656,095 shares in 2007	(204)	(191)
Total stockholders equity	5,324	5,280
Total liabilities and stockholders equity	$ 25,226	$ 24,579

See accompanying notes.

Table of Contents

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

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Cash flows from operating activities		
Net income	$ 410	$ 795
Less income from discontinued operations, net of income taxes		674
Income from continuing operations	410	121
Adjustments to reconcile net income to net cash from operating activities		
Depreciation, depletion and amortization	611	557
Deferred income tax expense	236	42
Earnings from unconsolidated affiliates, adjusted for cash distributions	(8)	40
Loss on debt extinguishment		287
Other non-cash income items	36	13
Asset and liability changes	33	(178)
Cash provided by continuing activities	1,318	882
Cash used in discontinued activities		(17)
Net cash provided by operating activities	1,318	865
Cash flows from investing activities		
Capital expenditures	(1,175)	(1,130)
Cash paid for acquisitions	(336)	(270)
Net proceeds from the sale of assets and investments	659	80
Other	43	20
Cash used in continuing activities	(809)	(1,300)
Cash provided by discontinued activities		3,660
Net cash provided by (used in) investing activities	(809)	2,360
Cash flows from financing activities		
Net proceeds from issuance of long-term debt	2,670	3,666
Payments to retire long-term debt and other financing obligations	(3,071)	(6,765)
Dividends paid	(75)	(75)
Payments to minority interest holders	(12)	
Contributions from discontinued operations		3,360
Other	(32)	4
Cash provided by (used in) continuing activities	(520)	190

Cash used in discontinued activities		(3,643)
Net cash used in financing activities	(520)	(3,453)
Change in cash and cash equivalents	(11)	(228)
Cash and cash equivalents		
Beginning of period	285	537
End of period	$ 274	$ 309

See accompanying notes.

Table of Contents

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

	Quarters Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Net income	$ 191	$ 166	$ 410	$ 795
Pension and postretirement obligations:				
Unrealized actuarial losses arising during period (net of income taxes of $1 in 2008)			(2)	
Reclassification adjustments (net of income taxes of $3 and $5 in 2008 and $4 and $7 in 2007)	5	7	10	13
Cash flow hedging activities:				
Unrealized mark-to-market gains (losses) arising during period (net of income taxes of $152 and $222 in 2008 and $28 and $19 in 2007)	(272)	50	(395)	(33)
Reclassification adjustments for changes in initial value to the settlement date (net of income taxes of $21 and $22 in 2008 and $9 and $24 in 2007)	37	(15)	39	(40)
Investments available for sale:				
Unrealized gains on investments available for sale arising during period (net of income taxes of $2 in 2007)				3
Realized gains on investments available for sale arising during period (net of income taxes of $8 in 2007)		(15)		(15)
Other comprehensive income (loss)	(230)	27	(348)	(72)
Comprehensive income (loss)	$ (39)	$ 193	$ 62	$ 723

See accompanying notes.

7

Table of Contents

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

1. Basis of Presentation and Significant Accounting Policies

Basis of Presentation

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 U.S. generally accepted accounting principles. You should read this Quarterly Report on Form 10-Q along with our 2007 Annual Report on Form 10-K, which contains a summary of our significant accounting policies and other disclosures. The financial statements as of June 30, 2008, and for the quarters and six months ended June 30, 2008 and 2007, are unaudited. We derived the condensed consolidated balance sheet as of December 31, 2007, from the audited balance sheet filed in our 2007 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 our operating results for the entire year. Our financial statements for prior periods include reclassifications that were made to conform to the current period presentation. Those reclassifications did not impact our reported net income or stockholders equity.

Significant Accounting Policies

The information below provides an update of our significant accounting policies and accounting pronouncements issued but not yet adopted as discussed in our 2007 Annual Report on Form 10-K.

Fair Value Measurements. On January 1, 2008, we adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, for our financial assets and liabilities. We elected to defer the adoption of SFAS No. 157 for our non-financial assets and liabilities until January 1, 2009. The impact of adopting SFAS No. 157 was both a pre-tax increase to operating revenues of $6 million and to other comprehensive income of $4 million, and a reduction of our liabilities of $10 million, which represented the impact of the consideration of our credit standing in determining the value of our price risk management liabilities.

Measurement Date of Postretirement Benefits. Effective January 1, 2008, we adopted the measurement date provisions of 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)* and changed the measurement date of our postretirement benefit plans from September 30 to December 31. We recorded a $5 million decrease, net of income taxes of $2 million, to the January 1, 2008 accumulated deficit and a $3 million decrease, net of income taxes of $2 million, to the January 1, 2008 accumulated other comprehensive loss upon the adoption of the measurement date provisions of this standard to reflect an additional three months of net periodic benefit cost based on our September 30, 2007 measurement.

Derivative Instruments. In March 2008, the Financial Accounting Standards Board (FASB) issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133*, which requires expanded disclosures about derivative instruments. This standard requires companies to disclose their purpose for using derivative instruments, how those derivatives are accounted for under SFAS No. 133, and where the impacts of those derivatives are reflected in the financial statements. The provisions of this standard are effective for fiscal years beginning after November 15, 2008, and we are currently evaluating the impact that the adoption of this standard will have on our financial statement disclosures.

Table of Contents

2. Acquisitions and Divestitures

Acquisitions

Gulf LNG. In February 2008, we paid $295 million to complete the acquisition of a 50 percent interest in the Gulf LNG Clean Energy Project, an LNG terminal which is currently under construction in Pascagoula, Mississippi. The terminal is expected to be placed in service in late 2011 at an estimated total cost of $1.1 billion. In addition, we have a commitment to loan Gulf LNG up to $150 million under which we advanced $7 million as of June 30, 2008. Our partner in this project has a commitment to loan up to $64 million. We account for our investment in Gulf LNG using the equity method.

Exploration and Production properties. In June 2008, we acquired interests in onshore domestic natural gas and oil properties for approximately $43 million. In January 2007, we acquired operated natural gas and oil producing properties and undeveloped acreage in south Texas for approximately $254 million.

Divestitures

Under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we classify assets to be disposed of as discontinued operations when they have received appropriate approvals to be disposed of by our management or Board of Directors and when they meet other criteria. Cash flows from our discontinued businesses are reflected as discontinued operating, investing, and financing activities in our statement of cash flows. To the extent these operations do not maintain separate cash balances, we reflect the net cash flows generated from these businesses as a contribution to our continuing operations in cash from continuing financing activities.

Continuing operations asset sales. During the six months ended June 30, 2008, we sold natural gas and oil properties primarily in our Gulf of Mexico and Texas Gulf Coast regions for net cash proceeds of approximately $640 million. We also sold two power investments located in Central America and Asia. During the six months ended June 30, 2007, we received approximately $80 million of proceeds from the sales of assets and investments, primarily related to the sale of a pipeline lateral and our investment in the New York Mercantile Exchange (NYMEX).

Discontinued Operations. In February 2007, we sold ANR, our Michigan storage assets and our 50 percent interest in Great Lakes Gas Transmission for approximately $3.7 billion. During the first quarter of 2007, we recorded a gain on the sale of $648 million, net of taxes of $354 million. Included in the net assets of these discontinued operations as of the date of sale were net deferred tax liabilities assumed by the purchaser. Below is summarized income statement information regarding our discontinued operations:

	ANR and Related Operations (In millions)
Six Months Ended June 30, 2007	
Revenues	$ 101
Costs and expenses	(43)
Other expense	(7)
Interest and debt expense	(10)
Income taxes	(15)
Income from operations	26
Gain on sale, net of income taxes of $354 million[(1)]	648
Net income from discontinued operations	$ 674

(1) During the second quarter

of 2007, we recognized a $3 million loss, net of income taxes of $2 million, from discontinued operations related to a reduction of the gain on the sale of ANR primarily to reflect post-closing adjustments related to the sale.

Table of Contents

3. Income Taxes

Income taxes included in our income from continuing operations for the periods ended June 30 were as follows:

	Quarters Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(In millions, except for rates)			
Income taxes	$ 87	$ 70	$ 235	$ 51
Effective tax rate	31%	29%	36%	30%

We compute interim period income taxes by applying an anticipated annual effective tax rate to our year-to-date income or loss, except for significant unusual or infrequently occurring items. Significant tax items are recorded in the period that the item occurs.

In the second quarter of 2008, our effective tax rate was primarily impacted by the tax impact of the settlement of legacy litigation matters. For the six months ended June 30, 2008, this impact was largely offset by the tax impact of adjusting our postretirement benefit obligations. Our 2007 overall effective tax rate on continuing operations was lower than the statutory rate of 35 percent primarily due to tax benefits associated with tax law changes and dividend exclusions on earnings from unconsolidated affiliates where we anticipate receiving dividends. These reductions were partially offset by state income taxes (net of federal income tax effects) and the reversal of deferred tax assets on certain foreign investments.

We file income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. With a few exceptions, we are no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 1999. In June 2008, the Internal Revenue Service s examination of El Paso s U.S. income tax returns for 2003 and 2004 was settled at the appellate level with approval by the Joint Committee on Taxation. The settlement of issues raised in this examination did not materially impact our results of operations, financial condition or liquidity. For our remaining open tax years, our unrecognized tax benefits (liabilities for uncertain tax matters) could increase or decrease our income tax expense and effective income tax rates as these matters are finalized, although we are unable to estimate the range of potential impacts these matters could have on our financial statements.

As of January 1, 2008 and June 30, 2008, we had unrecognized tax benefits of $157 million and $125 million. The reduction in these amounts was primarily associated with the settlement of the 2003 and 2004 Internal Revenue Service audits and was recorded as an adjustment to additional paid in capital. Approximately $132 million as of January 1, 2008 and $121 million as of June 30, 2008 (net of federal tax benefits) would favorably affect our income tax expense and our effective income tax rate if recognized in future periods. While the amount of our unrecognized tax benefits could change in the next twelve months, we do not expect this change to have a significant impact on our results of operations or financial position.

Table of Contents

4. Earnings Per Share

We calculated basic and diluted earnings per common share as follows:

	2008		2007	
	Basic	Diluted	Basic	Diluted
	(In millions, except per share amounts)			
Quarters Ended June 30				
Income from continuing operations	$ 191	$ 191	$ 169	$ 169
Convertible preferred stock dividends[1]			(10)	
Income from continuing operations available to common stockholders	191	191	159	169
Discontinued operations, net of income taxes			(3)	(3)
Net income available to common stockholders	$ 191	$ 191	$ 156	$ 166
Weighted average common shares outstanding	698	698	696	696
Effect of dilutive securities:				
Options and restricted stock		5		4
Convertible preferred stock		58		57
Weighted average common shares outstanding and dilutive securities	698	761	696	757
Earnings per common share:				
Income from continuing operations	$ 0.27	$ 0.25	$ 0.23	$ 0.22
Discontinued operations, net of income taxes				
Net income	$ 0.27	$ 0.25	$ 0.23	$ 0.22

	2008		2007	
	Basic	Diluted	Basic	Diluted
	(In millions, except per share amounts)			
Six Months Ended June 30				
Income from continuing operations	$ 410	$ 410	$ 121	$ 121
Convertible preferred stock dividends	(19)		(19)	(19)
Income from continuing operations available to common stockholders	391	410	102	102
Discontinued operations, net of income taxes			674	674
Net income available to common stockholders	$ 391	$ 410	$ 776	$ 776
Weighted average common shares outstanding	698	698	695	695
Effect of dilutive securities:				

Options and restricted stock		4		4
Convertible preferred stock		58		
Weighted average common shares outstanding and dilutive securities	698	760	695	699
Earnings per common share:				
Income from continuing operations	$ 0.56	$ 0.54	$ 0.15	$ 0.15
Discontinued operations, net of income taxes			0.97	0.96
Net income	$ 0.56	$ 0.54	$ 1.12	$ 1.11

(1) Dividends were declared in February and March 2008. No dividends were declared during the quarter ended June 30, 2008.

We exclude potentially dilutive securities (such as employee stock options, restricted stock, convertible preferred stock and trust preferred securities) from the determination of diluted earnings per share when their impact on income from continuing operations per common share is antidilutive. For the quarter and six months ended June 30, 2008 and 2007, certain of our employee stock options and our trust preferred securities were antidilutive. Also, our convertible preferred stock for the six months ended June 30, 2007 was antildilutive. For a further discussion of our potentially dilutive securities, see our 2007 Annual Report on Form 10-K.

Table of Contents

5. Fair Value Measurements

On January 1, 2008, we adopted the provisions of SFAS No. 157, *Fair Value Measurements*, and SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, for our financial assets and liabilities. SFAS No. 157 expands the disclosure requirements for financial instruments and other derivatives recorded at fair value, and also requires that a company s own credit risk be considered in determining the fair value of those instruments. The adoption of SFAS No. 157 resulted in a $6 million increase in operating revenues, a $4 million pre-tax increase in other comprehensive income, and a $10 million reduction of our liabilities to reflect the consideration of our credit risk on our liabilities that are recorded at fair value. SFAS No. 159 provided us the option to record most financial assets and liabilities at fair value on an instrument-by-instrument basis with changes in their fair value reported through the income statement. The adoption of SFAS No. 159 had no impact on our financial statements as we elected not to apply fair value accounting at adoption for our applicable financial assets and liabilities.

We use various methods to determine the fair values of our financial instruments and other derivatives which depend on a number of factors, including the availability of observable market data over the contractual term of the underlying instrument. For some of our instruments, the fair value is calculated based on directly observable market data or data available for similar instruments in similar markets. For other instruments, the fair value may be calculated based on these inputs as well as other assumptions related to estimates of future settlements of these instruments. We separate our financial instruments and other derivatives into three levels (Levels 1, 2 and 3) based on our assessment of the availability of observable market data and the significance of non-observable data used to determine the fair value of our instruments. Our assessment of an instrument can change over time based on the maturity or liquidity of the instrument, which could result in a change in the classification of the instruments between levels. Each of these levels and our corresponding instruments classified by level are further described below:

Level 1 instruments fair values are based on quoted prices in actively traded markets. Included in this level are our marketable securities invested in non-qualified compensation plans whose fair value is determined using quoted prices of these instruments.

Level 2 instruments fair values are based on pricing data representative of quoted prices for similar assets and liabilities in active markets (or identical assets and liabilities in less active markets). Included in this level are our production-related natural gas and oil derivatives and certain of our other natural gas derivatives (such as natural gas supply arrangements) whose fair values are based on commodity pricing data obtained from an independent pricing source.

Level 3 instruments fair values are partially calculated using pricing data that is similar to Level 2 above, but their fair value also reflects adjustments for being in less liquid markets or having longer contractual terms. For these instruments, we use available pricing data adjusted for liquidity and/or contractual terms to develop an estimate of forward price curves. The curves are then used to estimate the value of settlements in future periods based on contractual settlement quantities and dates. Our valuation of these instruments considers specific contractual terms, statistical and simulation analysis, present value concepts and other internal assumptions related to (i) contract maturities that extend beyond the periods in which quoted market prices are available; (ii) the uniqueness of the contract terms and (iii) the lack of viable market participants. Since a significant portion of the fair value of our power-related derivatives, foreign currency swaps and certain of our remaining natural gas derivatives with longer terms or in less liquid markets than similar Level 2 derivatives, rely on the techniques discussed above, we classify these instruments as Level 3 instruments.

Table of Contents

Listed below are the fair values of our financial instruments classified in each level at June 30, 2008 (in millions):

	Level 1	Level 2	Level 3	Total
Assets				
Marketable securities invested in non-qualified compensation plans	$ 20	$	$	$ 20
Production-related natural gas and oil derivatives		3		3
Other natural gas derivatives		44	46	90
Power-related derivatives			164	164
Foreign currency swaps			132	132
Total assets	$ 20	$ 47	$ 342	$ 409

	Level 1	Level 2	Level 3	Total
Liabilities				
Production-related natural gas and oil derivatives	$	$ (714)	$	$ (714)
Other natural gas derivatives		(183)	(209)	(392)
Power-related derivatives			(736)	(736)
Interest rate swaps		(7)		(7)
Other			(67)	(67)
Total liabilities		(904)	(1,012)	(1,916)
Total	$ 20	$ (857)	$ (670)	$ (1,507)

The following table presents the changes in our financial assets and liabilities included in Level 3 for the quarter and six months ended June 30, 2008 (in millions):

Quarter Ended June 30, 2008

	Balance at Beginning of Period	Change in fair value reflected in operating revenues(1)	Change in fair value reflected in operating expenses(2)	Change in fair value reflected in long-term financing obligations(3)	Settlements, Net	Balance at End of Period
Assets	$ 332	$ 58	$	$ (39)	$ (9)	$ 342
Liabilities	(913)	(154)	13		42	(1,012)
Total	$ (581)	$ (96)	$ 13	$ (39)	$ 33	$ (670)

Six Months Ended June 30, 2008

	Balance at Beginning of Period	Change in fair value reflected in operating revenues(1)	Change in fair value reflected in operating expenses(2)	Change in fair value reflected in long-term financing obligations(3)	Settlements, Net	Balance at End of Period
Assets	$ 250	$ 90	$	$ 20	$ (18)	$ 342
Liabilities	(839)	(224)	(31)		82	(1,012)

Total	$	(589)	$	(134)	$	(31)	$	20	$	64	$	(670)

(1) Includes approximately $92 million and $133 million of net losses that had not been realized through settlements for the quarter and six months ended June 30, 2008.

(2) Includes approximately $12 million of net gains and $26 million of net losses that had not been realized through settlements for the quarter and six months ended June 30, 2008.

(3) Includes approximately $39 million of net losses and $20 million of net gains that had not been realized through settlements for the quarter and six months ended June 30, 2008.

Table of Contents

6. Price Risk Management Activities

The following table summarizes the carrying value of the derivatives used in our price risk management activities. In the table below, derivatives designated as accounting hedges consist of instruments used to hedge our natural gas and oil production. Other commodity-based derivative contracts relate to derivative contracts not designated as accounting hedges, such as options and swaps, other natural gas and power purchase and supply contracts, and derivatives related to our legacy energy trading activities. Interest rate and foreign currency derivatives consist of swaps that are primarily designated as accounting hedges of our interest rate and foreign currency risk on long-term debt.

	June 30, 2008	December 31, 2007
	(In millions)	
Net assets (liabilities):		
Derivatives designated as accounting hedges	$ (581)	$ (23)
Other commodity-based derivative contracts	(1,004)	(869)
Total commodity-based derivatives	(1,585)	(892)
Interest rate and foreign currency derivatives	125	109
Net liabilities from price risk management activities[1]	$ (1,460)	$ (783)

(1) Included in both current and non-current assets and liabilities on the balance sheet.

7. Long-Term Financing Obligations and Other Credit Facilities

	June 30, 2008	December 31, 2007
	(In millions)	
Current maturities of long-term financing obligations	$ 1,236	$ 331
Long-term financing obligations	11,223	12,483
Total	$ 12,459	$ 12,814

Long Term Financing Obligations. During the second quarter of 2008, we repurchased approximately $289 million of our subsidiary debt obligations and issued $600 million of unsecured senior notes that mature in June 2018. Interest accrues on the issued notes at a rate of 7.25% per year and is payable semiannually. We applied the net proceeds from these notes to reduce outstanding borrowings under our credit facilities.

Credit Facilities. As of June 30, 2008, we had available capacity under various credit agreements of approximately $1.5 billion. During the second quarter of 2008, we made net repayments of $275 million under our $1.5 billion revolving credit facility bringing the debt outstanding to zero. As of June 30, 2008, we had approximately $0.3 billion of letters of credit issued under this facility. Additionally, as of June 30, 2008, (i) substantially all of the $1.0 billion of capacity under our various other unsecured revolving credit facilities was used to issue letters of credit and

(ii) approximately $0.7 billion was outstanding under our El Paso Exploration & Production Company (EPEP) $1.0 billion revolving credit facility.

During 2008, El Paso Pipeline Partners, L.P. (EPB), our master limited partnership (MLP), had net additional borrowings of $40 million under its credit facility. As of June 30, 2008, the total amount outstanding under the facility was $495 million. The EPB borrowings are not recourse to El Paso and the facility is solely available for use by EPB and its subsidiaries.

Letters of Credit. We enter into letters of credit in the ordinary course of our operating activities as well as periodically in conjunction with the sales of assets or businesses. As of June 30, 2008, we had outstanding letters of credit of approximately $1.3 billion of which approximately $1.0 billion secure our recorded obligations related to price risk management activities.

Table of Contents

8. Commitments and Contingencies

Legal Proceedings

ERISA Class Action Suits. In December 2002, a purported class action lawsuit entitled *William H. Lewis, III v. El Paso Corporation, et al.* was filed in the U.S. District Court for the Southern District of Texas alleging that our communication with participants in our Retirement Savings Plan included various misrepresentations and omissions that caused members of the class to hold and maintain investments in El Paso stock in violation of the Employee Retirement Income Security Act (ERISA). Various motions have been filed and we are awaiting the court s ruling. We have insurance coverage for this lawsuit, subject to certain deductibles and co-pay obligations. We have established accruals for this matter which we believe are adequate.

Cash Balance Plan Lawsuit. In December 2004, a purported class action lawsuit entitled *Tomlinson, et al. v. El Paso Corporation and El Paso Corporation Pension Plan* was filed in U.S. District Court for Denver, Colorado. The lawsuit alleges various violations of ERISA and the Age Discrimination in Employment Act as a result of our change from a final average earnings formula pension plan to a cash balance pension plan. The claims that our cash balance plan violated ERISA were dismissed by the trial court. Our costs and legal exposure related to this lawsuit are not currently determinable.

Retiree Medical Benefits Matter. In 2002, a lawsuit entitled *Yolton et al. v. El Paso Tennessee Pipeline Co. and Case Corporation* was filed in a federal court in Detroit, Michigan. The lawsuit was filed on behalf of a group of retirees of Case Corporation (Case) that alleged they are entitled to retiree medical benefits under a medical benefits plan that we serve as plan administrator pursuant to a merger agreement with Tenneco Inc. Although we had asserted that our obligations under the plan were subject to a cap pursuant to an agreement with the union for Case employees, in the first quarter of 2008, the trial court granted summary judgment and ruled that the benefits were vested and not subject to the cap. As a result, we were obligated to pay the amounts above the cap and we adjusted our existing indemnification accrual using current actuarial assumptions and reclassified our liability as a postretirement benefit obligation. See Note 9 for a discussion of the impact of this matter. We intend to pursue appellate options following the determination by the trial court of any damages incurred by the plaintiffs during the period when premium payments above the cap were paid by the retirees. We believe our accruals established for this matter are adequate.

Price Reporting Litigation. Beginning in 2003, several lawsuits were filed against El Paso Marketing L.P. (EPM) alleging that El Paso, EPM and other energy companies conspired to manipulate the price of natural gas by providing false price information to industry trade publications that published gas indices. The first set of cases, involving similar allegations on behalf of commercial and residential customers, was transferred to a multi-district litigation proceeding (MDL) in the U.S. District Court for Nevada and styled In re: Western States Wholesale Natural Gas Antitrust Litigation. These cases were dismissed. The U.S. Court of Appeals for the Ninth Circuit, however, reversed the dismissal and ordered that these cases be remanded to the trial court. The second set of cases also involve similar allegations on behalf of certain purchasers of natural gas. These include Farmland Industries v. Oneok Inc., et al. (filed in state court in Wyandotte County, Kansas in July 2005) and Missouri Public Service Commission v. El Paso Corporation, et al. (filed in the circuit court of Jackson County, Missouri at Kansas City in October 2006), and the purported class action lawsuits styled: Leggett, et al. v. Duke Energy Corporation, et al. (filed in Chancery Court of Tennessee in January 2005); Ever-Bloom Inc., et al. v. AEP Energy Services Inc., et al. (filed in federal court for the Eastern District of California in September 2005); Learjet, Inc., et al. v. Oneok Inc., et al. (filed in state court in Wyandotte County, Kansas in September 2005); Breckenridge, et al. v. Oneok Inc., et al. (filed in state court in Denver County, Colorado in May 2006); Arandell, et al. v. Xcel Energy, et al. (filed in the circuit court of Dane County, Wisconsin in December 2006); and Heartland, et al. v. Oneok Inc., et al. (filed in the circuit court of Buchanan County, Missouri in March 2007). The Leggett case was dismissed by the Tennessee state court and has been appealed. The Missouri Public Service case was transferred to the MDL, but remanded back to state court, where a motion to dismiss has been filed. The remaining cases have all been transferred to the MDL proceeding. The Breckenridge Case has been dismissed, but a motion for reconsideration was filed. Motions for summary judgment in Learjet and Farmland were denied, but a motion for reconsideration has been filed. Discovery is proceeding in the MDL cases. Our costs and legal exposure related to these lawsuits and claims are not currently determinable.

Table of Contents

Gas Measurement Cases. A number of our subsidiaries 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 and have 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 October 2006, the U.S. District Judge issued an order dismissing all claims against all defendants. An appeal has been filed.

Similar allegations were filed in a second set of actions initiated 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 plaintiff seeks 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 these lawsuits and claims are not currently determinable.

MTBE. Certain of our subsidiaries used the gasoline additive methyl tertiary-butyl ether (MTBE) in some of their gasoline. Certain subsidiaries also produced, bought, sold and distributed MTBE. A number of lawsuits have been filed throughout the U.S. regarding the potential impact of MTBE on water supplies. Some of our subsidiaries are among the defendants in approximately 81 such lawsuits. The plaintiffs, certain state attorneys general, various water districts and a limited number of individual water customers, generally seek remediation of their groundwater, prevention of future contamination, damages (including natural resource damages), punitive damages, attorney s fees and court costs. Although these suits had been consolidated for pre-trial purposes in multi-district litigation in the U.S. District Court for the Southern District of New York, a limited number of cases have since been remanded to separate state court proceedings. It is possible many of the other cases will also be remanded. We have reached an agreement with the plaintiffs to settle approximately 59 of the lawsuits. We have also reached an agreement with our insurers, whereby our insurers would fund substantially all of the consideration to be provided by our subsidiaries under the terms of the settlement with the plaintiffs. The settlement is subject to the approval of several courts, one of which has approved it. The settlement will become effective upon the approval of the remaining courts and the exhaustion of all appellate rights. Approximately 22 of the remaining lawsuits are not covered by the terms of this settlement. While the damages claimed in these remaining actions are substantial, there remains significant legal uncertainty regarding the validity of the causes of action asserted and the availability of the relief sought by the plaintiffs. We have tendered these remaining cases to our insurers. Our costs and legal exposure related to these remaining lawsuits are not currently determinable.

Government Investigations and Inquiries

Reserve Revisions. In March 2004, we received a subpoena from the SEC requesting documents relating to our December 31, 2003 natural gas and oil reserve revisions. We originally self-reported this matter to the SEC and cooperated with the SEC in its investigation. On July 10, 2008, the SEC approved a settlement entered into by El Paso Corporation and two of its subsidiaries, El Paso Exploration and Production and El Paso CGP (which was formerly known as The Coastal Corporation), that fully resolves the previously disclosed SEC s investigation of our oil and gas reserve estimates for periods prior to 2004. Pursuant to the terms of the settlement, no monetary fine or penalty has been imposed upon the companies and, without admitting or denying any wrongdoing, the companies consented to the entry of a cease and desist order with respect to various provisions of the Securities Act of 1933, the Securities Exchange Act of 1934 and related SEC rules.

In addition to the above proceedings, we and our subsidiaries and affiliates are named defendants in numerous lawsuits and governmental proceedings that arise in the ordinary course of our business. There are also other regulatory rules and orders in various stages of adoption, review and/or implementation. For each of these 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. While the outcome of these matters, including those discussed above, cannot be predicted with certainty, and there are still uncertainties related to the costs we may incur, based upon our evaluation and experience to date, we believe we have established appropriate reserves for these matters. It is possible, however, that new information or future developments could require us to reassess our potential exposure

Table of Contents

related to these matters and adjust our accruals accordingly, and these adjustments could be material. As of June 30, 2008, we had approximately $120 million accrued, which has not been reduced by $33 million of related insurance receivables, for outstanding legal and governmental proceedings.

Rates and Regulatory Matters

Notice of Inquiry on Pipeline Fuel Retention Policies. In September 2007, the Federal Energy Regulatory Commission (FERC) issued a Notice of Inquiry regarding its policy about the in-kind recovery of fuel and lost and unaccounted for gas by natural gas pipeline companies. Under current policy, pipelines have options for recovering these costs. For some pipelines, the tariff states the recovery of a fixed percentage as a non-negotiable fee-in-kind retained from the volumes tendered for shipment by each shipper. There is also a tracker approach, where the pipeline s tariff provides for prospective adjustments to the fuel retention rates from time-to-time, but does not include a mechanism to allow the pipeline to reconcile past over or under-recoveries of fuel. Finally, some pipelines tariffs provide for a tracker with a true-up approach, where provisions in a pipeline s tariff allow for periodic adjustments to the fuel retention rates, and also provide for a true-up of past over and under-recoveries of fuel and lost and unaccounted for gas. In this proceeding, the FERC is seeking comments on whether it should change its current policy and prescribe a uniform method for all pipelines to use in recovering these costs. Our pipeline subsidiaries currently utilize a variety of these methodologies. At this time, we do not know what impact, if any, this proceeding may ultimately have on our pipeline subsidiaries.

EPNG Rate Case. In June 2008, El Paso Natural Gas Company (EPNG) filed a rate case with the FERC as required under the settlement of its previous rate case. The filing proposes an increase in EPNG s base tariff rates which would increase revenue by $83 million annually over current tariff rates. In August 2008, the FERC issued an order accepting and suspending the effective date of the proposed rates to January 1, 2009, subject to refund and the outcome of a hearing and technical conference.

Notice of Proposed Rulemaking. On October 3, 2007, the Minerals Management Service (MMS) issued a Notice of Proposed Rulemaking for Oil and Gas and Sulphur Operations in the Outer Continental Shelf (OCS) Pipelines and Pipeline Rights-of-Way. If adopted, the proposed rules would substantially revise MMS OCS pipeline and rights-of-way regulations. The proposed rules would have the effect of: (1) increasing the financial obligations of entities, like us, which have pipelines and pipeline rights-of-way in the OCS; (2) increasing the regulatory requirements imposed on the operation and maintenance of existing pipelines in the OCS; and (3) increasing the requirements and preconditions for obtaining new rights-of-way in the OCS.

Greenhouse Gas Emissions. In July, 2008, the U.S. Environmental Protection Agency (EPA) requested public comments on the potential regulation of greenhouse gases (GHGs) under the Clean Air Act. Some of the regulatory alternatives identified by the EPA in its request for comments, if eventually promulgated as final rules, would likely impact our operations and financial results. It is uncertain whether the EPA will proceed with adopting final rules or whether the regulation of the GHGs will be addressed in federal and state legislation. Since it is uncertain what, if any, regulatory or legislative alternatives may be adopted, it is not possible at this time to determine whether and how such laws or regulations could impact our operations and financial results and whether those impacts will be material to our financial statements.

Other Matter

Navajo Nation. Approximately 900 looped pipeline miles of the north mainline of our EPNG pipeline system are located on lands held in trust by the United States for the benefit of the Navajo Nation. Our rights-of-way on lands crossing the Navajo Nation are the subject of a pending renewal application filed in 2005 with the Department of the Interior s Bureau of Indian Affairs. In June 2008, EPNG reached an agreement in principle on the fundamental economic terms of a tribal consent extension through October 2025. Based on the preliminary agreement, EPNG made payments to the Navajo Nation covering the period from January 2007 through October 2008. Negotiations on the remaining terms and conditions are continuing. We have filed with the FERC for recovery of these amounts in our recent rate case, but are uncertain as to whether such recovery will be allowed.

Environmental Matters

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. As of June 30, 2008, we had accrued approximately $244 million for environmental matters, which has not been reduced by $24 million for amounts to be paid directly under government sponsored programs. Our accrual includes approximately $236 million for expected remediation costs and associated onsite, offsite and groundwater technical studies and approximately $8 million for related environmental legal costs. Of the $244 million accrual, $20 million was reserved for facilities we currently operate and $224 million was reserved for non-operating sites (facilities that are shut down or have been sold) and Superfund sites.

Our estimates of potential liability range from approximately $244 million to approximately $450 million. Our accrual represents a combination of two estimation methodologies. First, where the most likely outcome can be reasonably estimated, that cost has been accrued ($14 million). Second, where the most likely outcome cannot be estimated, a range of costs is established ($230 million to $436 million) 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 environmental remediation projects are in various stages of completion. Our recorded liabilities 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. By type of site, our reserves are based on the following estimates of reasonably possible outcomes:

	June 30, 2008	
Sites	**Expected**	**High**
	(In millions)	
Operating	$ 20	$ 26
Non-operating	200	376
Superfund	24	48
Total	$ 244	$ 450

Below is a reconciliation of our accrued liability from January 1, 2008 to June 30, 2008 (in millions):

Balance as of January 1, 2008	$ 260
Additions/adjustments for remediation activities	4
Payments for remediation activities	(20)
Balance as of June 30, 2008	$ 244

For the remainder of 2008, we estimate that our total remediation expenditures will be approximately $41 million, most of which will be expended under government directed clean-up plans. In addition, we expect to make capital expenditures for environmental matters of approximately $13 million in the aggregate for the years 2008 through 2012. These expenditures primarily relate to compliance with clean air regulations.

CERCLA Matters. As part of our environmental remediation projects, 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 39 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 indemnification by third-parties and settlements, which provide for payment of our allocable share of remediation costs. Because the clean-up costs are estimates and are subject to revision as more information becomes available about the extent of remediation required, and in some cases we have asserted a defense to any liability, our estimates could change. Moreover, liability under the federal CERCLA statute is joint and several, meaning that we could be required to pay in excess of our pro rata share of remediation costs. Our understanding of the financial strength of other PRPs has been considered, where appropriate, in estimating our liabilities. Accruals for these matters are included in the previously indicated estimates for Superfund sites.

Table of Contents

It is possible that new information or future developments could require us to reassess our potential exposure related to environmental matters. We may incur significant costs and liabilities in order to comply with existing environmental laws and regulations. It is also possible that other developments, such as increasingly strict environmental laws, regulations and orders of regulatory agencies, as well as claims for damages to property and the environment or injuries to employees and other persons resulting from our current or past operations, could result in substantial costs and liabilities in the future. As this information becomes available, or other relevant developments occur, we will 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 reserves are adequate.

Guarantees and Other Contractual Commitments

Guarantees. We are involved in various joint ventures and other ownership arrangements that sometimes require financial and performance guarantees. In a financial guarantee, we are obligated to make payments if the guaranteed party fails to make payments under, or violates the terms of, the financial arrangement. In a performance guarantee, we provide assurance that the guaranteed party will execute on the terms of the contract. If they do not, we are required to perform on their behalf. We also periodically provide indemnification arrangements related to assets or businesses we have sold. These arrangements include, but are not limited to, indemnifications for income taxes, the resolution of existing disputes, and environmental matters.

Our potential exposure under guarantee and indemnification agreements can range from a specified amount to an unlimited dollar amount, depending on the nature of the claim and the particular transaction. For those arrangements with a specified dollar amount, we have a maximum stated value of approximately $834 million, which primarily relates to indemnification arrangements associated with the sale of ANR, our Macae power facility in Brazil, and other legacy assets. These amounts exclude guarantees for which we have issued related letters of credit discussed in Note 7. As of June 30, 2008, we have recorded obligations of $73 million related to our indemnification arrangements. This liability consists primarily of an indemnification that one of our subsidiaries provided related to its sale of an ammonia facility that is reflected in our financial statements at its fair value. We have provided a partial parental guarantee of our subsidiary s obligations under this indemnification. We are unable to estimate a maximum exposure for our guarantee and indemnification agreements that do not provide for limits on the amount of future payments due to the uncertainty of these exposures.

Other Purchase Obligations. We have entered into contracts to purchase approximately $1.0 billion of pipe associated with the Ruby Pipeline project and TGP s Line 300 project which are anticipated to be placed in service between 2010 and 2011. Our estimated annual obligations under these agreements are approximately $0.3 billion for the remainder of 2008, $0.6 billion in 2009 and $0.1 billion in 2010.

9. Retirement Benefits

Net Benefit Cost. The components of net benefit cost for our pension and postretirement benefit plans for the periods ended June 30 are as follows:

	Quarters Ended June 30,				Six Months Ended June 30,			
	Pension Benefits		Other Postretirement Benefits		Pension Benefits		Other Postretirement Benefits	
	2008	2007	2008	2007	2008	2007	2008	2007
	(In millions)							
Service cost	$ 3	$ 4	$	$	$ 7	$ 9	$	$
Interest cost	30	30	10	7	60	60	17	13
Expected return on plan assets	(46)	(46)	(4)	(4)	(93)	(91)	(8)	(8)
Amortization of net actuarial loss (gain)	6	11	(1)		12	21	(2)	
Amortization of prior service cost[1]			(1)	(1)	(1)	(1)	(1)	(1)
Net benefit cost (income)	$ (7)	$ (1)	$ 4	$ 2	$ (15)	$ (2)	$ 6	$ 4

(1) As permitted, the amortization of any prior service cost is determined using a straight-line amortization of the cost over the average remaining service period of employees expected to receive benefits under the plan.

Other Matters. In various court rulings prior to March 2008, we were required to indemnify Case Corporation for certain benefits paid to a closed group of Case retirees as further discussed in Note 8. In conjunction with those rulings, we recorded a liability for estimated amounts due under the indemnification using actuarial methods similar to those used in estimating our postretirement benefit plan obligations. This liability, however, was not included in our postretirement benefit obligations or disclosures.

In March 2008, we received a summary judgment from the trial court on this matter that we effectively became the primary party that is obligated to pay for these benefit payments. As a result of the judgment, we adjusted our obligation using current actuarial assumptions, recording a $65 million reduction to current and non-current other liabilities and to operation and maintenance expense. We also reclassified this obligation from an indemnification liability to a postretirement benefit obligation, which increased our overall postretirement benefit obligations by

$280 million.

Due to the addition of the Case retirees described above, we now expect payments under our postretirement benefit plans, net of participant contributions and Medicare subsidies, to be approximately $62 million each year through 2012 and $287 million in total for the five year period from 2013 to 2017.

For the remainder of 2008, we expect to contribute an additional $33 million to our other postretirement benefit plans.

Table of Contents

10. Stockholders Equity

The table below shows the amount of dividends paid and declared in 2008 (dollars in millions).

	Common Stock ($0.04/Share)	Convertible Preferred Stock (4.99%/Year)
Amount paid through June 30, 2008	$ 56	$ 19
Amount paid in July 2008	$ 28	$ 9
Dividends declared subsequent to June 30, 2008		
Date of declaration	July 25, 2008	July 25, 2008
Payable to shareholders on record	September 5, 2008	September 15, 2008
Date payable	October 1, 2008	October 1, 2008

Dividends on our common stock and preferred stock are treated as a reduction of additional paid-in-capital since we currently have an accumulated deficit. For the remainder of 2008, we expect dividends paid on our common and preferred stock will be taxable to our stockholders because we anticipate they will be paid out of current or accumulated earnings and profits for tax purposes. On May 15, 2008, our Board of Directors declared a dividend of $0.05 per share for our common shareholders. The dividend will be payable on October 1, 2008 to holders of record on September 5, 2008.

The terms of our 750,000 outstanding shares of 4.99% convertible preferred stock prohibit the payment of dividends on our common stock unless we have paid or set aside for payment all accumulated and unpaid dividends on such preferred stock for all preceding dividend periods. In addition, although our credit facilities do not contain any direct restriction on the payment of dividends, dividends are included as a fixed charge in the calculation of our fixed charge coverage ratio under our credit facilities. If our fixed charge ratio were to exceed the permitted maximum level, our ability to pay additional dividends would be restricted.

11. Business Segment Information

As of June 30, 2008, our business consists of two core segments, Pipelines and Exploration and Production. We also have Marketing and Power segments. Our segments are strategic business units that provide a variety of energy products and services. They are managed separately as each segment requires different technology and marketing strategies. Our corporate operations include our general and administrative functions, as well as other miscellaneous businesses and other various contracts and assets, all of which are immaterial. A further discussion of each segment follows.

Pipelines. Provides natural gas transmission, storage, and related services, primarily in the United States. As of June 30, 2008, we conducted our activities primarily through seven wholly or majority owned interstate pipeline systems and equity interests in three interstate transmission systems. We also own or have interests in two underground natural gas storage facilities, an LNG terminalling facility, and an LNG terminalling facility which is under construction.

Exploration and Production. Engaged in the exploration for and the acquisition, development and production of natural gas, oil and NGL in the United States, Brazil and Egypt.

Marketing. Markets and manages the price risks associated with our natural gas and oil production as well as our remaining legacy trading portfolio.

Power. Manages the risks associated with our remaining international power investments located primarily in South America and Asia. We continue to pursue the sale of these assets.

Table of Contents

Our management uses earnings before interest expense and income taxes (EBIT) to assess the operating results and effectiveness of our business segments which consist of both consolidated businesses and investments in unconsolidated affiliates. We believe EBIT is useful to our investors because it allows them to more effectively evaluate the operating performance using the same performance measure analyzed internally by our management. We define EBIT as net income or loss adjusted for (i) items that do not impact our income or loss from continuing operations, such as discontinued operations, (ii) income taxes and (iii) interest and debt expense. We exclude interest and debt expense so that investors may evaluate our operating results without regard to our financing methods or capital structure. EBIT may not be comparable to measures used by other companies. Additionally, EBIT should be considered in conjunction with net income and other performance measures such as operating income or operating cash flow. Below is a reconciliation of our EBIT to our income from continuing operations for the periods ended June 30:

	Quarters Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(In millions)			
Segment EBIT	$ 458	$ 574	$ 1,019	$ 1,000
Corporate and other	41	(104)	80	(314)
Interest and debt expense	(221)	(231)	(454)	(514)
Income taxes	(87)	(70)	(235)	(51)
Income from continuing operations	$ 191	$ 169	$ 410	$ 121

The following table reflects our segment results for the periods ended June 30:

	Segments					
	Pipelines	Exploration and Production	Marketing	Power	Corporate and Other(1)	Total
	(In millions)					
Quarters Ended June 30, 2008						
Revenue from external customers	$632	$ 198(2)	$ 322	$	$ 1	$1,153
Intersegment revenue	14	457(2)	(468)		(3)	
Operation and maintenance	205	105	8	4	(40)	282
Depreciation, depletion and amortization	99	197			2	298
Earnings from unconsolidated affiliates	25	16		11		52
EBIT	295	304	(153)	12	41	499
2007						
Revenue from external customers	$600	$ 268(2)	$ 301	$	$ 29	$1,198
Intersegment revenue	14	307(2)	(317)		(4)	
Operation and maintenance	181	110	3	7	28	329
	91	189	1		5	286

Depreciation, depletion and amortization						
Earnings (losses) from unconsolidated affiliates	29	3		13	(1)	44
EBIT	318	235	5	16	(104)[3]	470

(1) Includes eliminations of intercompany transactions. Our intersegment revenues, along with our intersegment operating expenses, were incurred in the normal course of business between our operating segments. During the quarters ended June 30, 2008 and 2007, we recorded an intersegment revenue elimination of $5 million and $4 million in the Corporate and Other column to remove intersegment transactions.

(2) Revenues from external customers include gains and losses related to our price risk management activities associated with our natural gas and oil

production. Intersegment revenues represent sales to our Marketing segment, which is responsible for marketing our production to third parties.

(3) Debt and treasury management activities, which are part of Corporate and Other, included debt extinguishment costs of $86 million for the quarter ended June 30, 2007 primarily related to refinancing of EPEP s $1.2 billion notes.

Table of Contents

	Segments					
	Pipelines	Exploration and Production	Marketing	Power	Corporate and Other[1]	Total
			(In millions)			
Six Months Ended June 30, 2008						
Revenue from external customers	$1,339	$ 328(2)	$ 744	$	$ 11	$2,422
Intersegment revenue	27	930(2)	(947)		(10)	
Operation and maintenance	400	213	10	9	(79)	553
Depreciation, depletion and amortization	198	409			4	611
Earnings from unconsolidated affiliates	46	26		16	1	89
EBIT	676	546	(213)	10	80	1,099
2007						
Revenue from external customers	$1,231	$ 488(2)	$ 460	$	$ 41	$2,220
Intersegment revenue	27	592(2)	(611)		(8)	
Operation and maintenance	342	220	3	11	54	630
Depreciation, depletion and amortization	185	359	2		11	557
Earnings from unconsolidated affiliates	55	2		24		81
EBIT	682	414	(130)	34	(314)[3]	686

(1) Includes eliminations of intercompany transactions. Our intersegment revenues, along with our intersegment operating expenses, were incurred in the normal course of business between our operating segments. During the six months ended

June 30, 2008 and 2007, we recorded an intersegment revenue elimination of $10 million and $9 million in the Corporate and Other column to remove intersegment transactions.

(2) Revenues from external customers include gains and losses related to our price risk management activities associated with our natural gas and oil production. Intersegment revenues represent sales to our Marketing segment, which is responsible for marketing our production to third parties.

(3) Debt and treasury management activities, which are part of Corporate and Other, included debt extinguishment costs of $287 million for the six months ended June 30,

2007, $86 million of which is related to refinancing of EPEP s $1.2 billion notes.

Total assets by segment are presented below:

	June 30, 2008	December 31, 2007
	(In millions)	
Pipelines	$ 14,537	$ 13,939
Exploration and Production	7,663	8,029
Marketing	675	537
Power	498	531
Total segment assets	23,373	23,036
Corporate and Other	1,853	1,543
Total consolidated assets	$ 25,226	$ 24,579

23

Table of Contents

12. Investments in, Earnings from and Transactions with Unconsolidated Affiliates

We hold investments in unconsolidated affiliates which are accounted for using the equity method of accounting. The earnings from unconsolidated affiliates reflected in our income statement include (i) our share of net earnings directly attributable to these unconsolidated affiliates, and (ii) any impairments and other adjustments recorded by us. The information below related to our unconsolidated affiliates includes (i) our net investment and earnings (losses) we recorded from these investments, (ii) summarized financial information of our proportionate share of these investments, and (iii) revenues and charges with our unconsolidated affiliates.

			Earnings (Losses) from Unconsolidated Affiliates			
	Investment		Quarters Ended		Six Months Ended	
	June 30,	December 31,	June 30,		June 30,	
Net Investment and Earnings (Losses)	2008	2007	2008	2007	2008	2007
	(In millions)		(In millions)			
Four Star [1]	$ 688	$ 698	$ 16	$ 3	$ 26	$ 2
Citrus	568	576	19	22	32	44
Gulf LNG[2]	295					
Bolivia to Brazil Pipeline	110	105	3	2	6	5
Gasoductos de Chihuahua	159	146	6	6	13	10
Manaus/Rio Negro[3]		56		5		9
Porto Velho[4]	(62)	(60)		5		7
Asian and Central American Investments[4][5]	17	26	6	(1)	6	(1)
Argentina to Chile Pipeline	24	21	2	2	3	3
Other	64	46			3	2
Total	$ 1,863	$ 1,614	$ 52	$ 44	$ 89	$ 81

(1) Amortization of our purchase cost in excess of the underlying net assets of Four Star was $13 million for the quarters ended June 30, 2008 and 2007 and $27 million for the six months ended June 30, 2008 and 2007. For a further discussion, see

our 2007 Annual Report on Form 10-K.

(2) In February 2008, we acquired a 50 percent interest in Gulf LNG. See Note 2.

(3) We transferred ownership of these plants to the power purchaser in January 2008. Accordingly, we eliminated our equity investments in these entities and retained current assets of $80 million and current liabilities of $24 million after the transfer. For a further discussion, see *Matters that Could Impact our Investments* below.

(4) As of June 30, 2008 and December 31, 2007, we had outstanding advances and receivables of $298 million and $350 million related to our foreign investments of

which $292 million and $335 million related to our investment in Porto Velho.

(5) In the second quarter of 2008, we sold our interests in our Khulna and Tipitapa power investments and recognized a pre-tax gain of $6 million.

Summarized Financial Information	Quarters Ended June 30, 2008	Quarters Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
	(In millions)			
Operating results data:				
Operating revenues	$194	$227	$380	$416
Operating expenses	84	132	177	243
Income from continuing operations	66	62	122	113
Net income(1)	66	62	122	113

(1) Includes net income of less than $1 million and $4 million for the quarters ended June 30, 2008 and 2007, and $1 million and $9 million for the six months ended June 30, 2008 and 2007, related to our proportionate share of affiliates in which we hold a greater than 50 percent interest.

We received distributions and dividends from our unconsolidated affiliates of $21 million and $64 million for the quarters ended June 30, 2008 and 2007 and $81 million and $138 million for the six months ended June 30, 2008 and 2007. Included in these amounts for the quarter and six months ended June 30, 2007 are returns of capital of $17 million. Our revenues and charges with unconsolidated affiliates were not material during the quarter and six months ended June 30, 2008. For the quarter and six months ended June 30, 2007, we recorded $12 million and $24 million in interest income primarily related to our note receivable with Porto Velho.

Matters that Could Impact Our Investments

Porto Velho. We have an equity investment in and a note receivable from the Porto Velho project in Brazil that totaled $230 million as of June 30, 2008. The Porto Velho facility generates power committed to a state-owned utility under power purchase agreements, the largest of which extends through 2023. In June of 2008, we signed a letter of intent to sell our investment in the project to our partner, subject to the execution of definitive agreements and the resolution of certain claims with the state-owned utility. These claims include those related to alleged excess fuel consumption by the plant during the period of 2003 to 2007 totaling approximately $60 million. We believe that we have valid defenses to these fuel claims. The state-owned utility has made additional net claims of $30 million for retroactive currency indexation adjustments through 2007, which are partially offset by retroactive revenue surcharges for periods through 2007 when the plant used oil for fuel. We are currently in negotiations with the utility to resolve these issues and any adverse developments in our negotiations with our partner or the utility could impact our ability to sell our investment in the project.

If we do not complete the sale of our interests in the project, our remaining investment in the Porto Velho project may be adversely impacted by developments in the Brazilian power market, which continues to evolve and mature. During 2007, the Brazilian national power grid operator communicated to Porto Velho s management that its power plant (and the region that the plant serves) will be interconnected to an integrated power grid in Brazil as soon as late 2008. When the interconnection is completed, the state-owned utility will have access to sources of power at rates that may be less than the price under Porto Velho s existing power purchase agreements. Furthermore, there are plans to construct new hydroelectric plants in northern Brazil that could reportedly be completed as early as 2012 which, once connected to the grid, could further reduce regional power prices and the amount of power Porto Velho will be able to sell under its power purchase agreements.

We recovered $45 million of our investment during the first half of 2008 and an additional $19 million in July 2008 through payments we received from the project. In conjunction with the negotiations on the sale of our investment, in July 2008, we and our partner extended to November 30, 2008 the date on which we will be required to convert into equity approximately $80 million of the amounts due to us under the note receivable from Porto Velho. In addition, we may be required to convert up to an additional $80 million of the note on November 30, 2008, depending on the level of equity that our partner contributes to the project. These potential equity conversions would occur only if we were unable to complete the sale of our interest to our partner. The conversions would not impact our total investment in the project, however they could increase our percentage ownership in Porto Velho while diluting our partner s ownership in the project.

During the second quarter of 2008, the Brazilian courts upheld a ruling that the statute of limitations had expired related to a $30 million fine assessed against the Porto Velho power project pertaining to filing certain tax forms for the delivery of fuel to the power facility in 2001. The Brazilian tax authorities exhausted their ability to appeal these rulings and, as a result, we believe that this matter has been resolved.

Table of Contents

Manaus /Rio Negro. On January 15, 2008, we transferred our ownership in the Manaus and Rio Negro facilities to the plants power purchaser as required by their power purchase agreements. As of June 30, 2008, we have approximately $72 million of Brazilian reais-denominated accounts receivable owed to us under the projects terminated power purchase agreements, which are guaranteed by the purchaser s parent. The purchaser has withheld payment of these receivables in light of their Brazilian reais-denominated claims of approximately $70 million related to plant maintenance the purchaser claims should have been performed at the plants prior to the transfer, inventory levels and other items. We have been in ongoing discussions with the purchaser about their claims, and early in the second quarter of 2008 we began discussions with the parent of the purchaser. Should these discussions fail and the purchaser not agree to payment of our receivables, we will initiate legal action against the purchaser to collect our receivables and defend against their claims, and ultimately we will seek legal action to enforce the parental guarantee related to our receivables. We have reviewed our obligations under the power purchase agreement in relation to the claims and have accrued an obligation for the uncontested claims. We believe the remaining contested claims are without merit. The ultimate resolution of each of these matters is unknown at this time. Adverse developments related to either our ability to collect amounts due to us or related to the dispute could require us to record additional losses in the future.

Asian power investments. As of June 30, 2008, we had a total investment (including advances to the projects) and guarantees related to our one remaining power plant investment in Asia of approximately $26 million. Any changes in political and economic conditions could negatively impact the amount we ultimately recover in the future on this investment.

Investment in Bolivia. We own an 8 percent interest in the Bolivia to Brazil pipeline. As of June 30, 2008, our total investment and guarantees related to this pipeline project was approximately $122 million, of which the Bolivian portion was $3 million. In 2006, the Bolivian government announced a decree significantly increasing its interest in and control over Bolivia s oil and gas assets. In June 2008, the Bolivian government took control of the majority owner of the Bolivian portion of the pipeline, but has taken no action with regard to our two percent interest in this portion of the pipeline. We continue to monitor and evaluate the potential commercial impact that these political events in Bolivia could have on our investment. As new information becomes available or future material developments arise, we may be required to record an impairment of our investment.

Investment in Argentina. We own an approximate 22 percent interest in the Argentina to Chile pipeline. As of June 30, 2008, our total investment in this pipeline project was approximately $24 million. The government of Argentina has issued decrees significantly increasing export taxes on natural gas transported on the Argentina-to-Chile pipeline. We continue to monitor and evaluate, together with our partners, the potential impact that these events in Argentina could have on our investment. In 2008, we executed a letter of intent to sell our interest to one of our partners, subject to the execution of definitive agreements and completion of due diligence by the buyer.

Table of Contents

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The information contained in Item 2 updates, and you should read it in conjunction with, information disclosed in our 2007 Annual Report on Form 10-K, and the financial statements and notes presented in Item 1 of this Quarterly Report on Form 10-Q.

Overview

Financial and Operational Update. During the first six months of 2008, our pipeline operations continued to provide a strong base of earnings and cash flow. Additionally, we continue to make progress on and grow our backlog of committed expansion projects, which is currently $8 billion. During 2008, our backlog increased primarily as a result of receiving long-term binding commitments for our Ruby Pipeline project and the Tennessee Gas Pipeline (TGP) Line 300 expansion. In our exploration and production business, we experienced continued success based on a favorable commodity price environment, an ongoing focus on increasing volumes, and effective cost management. In our Marketing segment, we incurred significant non-cash mark-to-market losses in the second quarter due primarily to volatility in locational power prices in the Pennsylvania New Jersey Maryland (PJM) power market.

Outlook. For 2008, we expect the current operating trends in our core pipeline and exploration and production businesses to continue with a focus on growth of these businesses. We anticipate that our pipeline operations will continue to provide strong operating results based on significant planned pipeline growth capital expenditures over the next five years including our $8 billion committed project backlog, current levels of contracted capacity, and recent rate and regulatory actions. In the pipeline industry, a favorable macroeconomic environment supports continued industry growth and we believe our systems are situated in locations that will allow us to be a participant in this growth. We will continue to pursue additional expansion projects, including proposed joint venture development projects that would use our incumbent pipeline infrastructure to connect supply areas to areas of high demand in the West, Northeast and Southeast. Finally, we are committed to growing our MLP through organic growth opportunities, potential acquisitions, or through future asset contributions. Our MLP provides us financial flexibility, a competitive cost of capital on expansion opportunities, and is a strategic growth vehicle for El Paso.

In our exploration and production business, we will continue to seek opportunities in our domestic regions to increase production levels, provide near-term cash flows and generate competitive investment returns. In addition, our international activities in Brazil and Egypt provide opportunity for additional future reserve additions and cash flows. In 2008, while our international capital is expected to be approximately 50 percent higher than 2007, we expect our domestic programs to constitute approximately 80 percent of our total planned capital and substantially all of our expected production.

In the first half of 2008, we received net proceeds of approximately $640 million on the sale of certain non-core properties primarily in our Texas Gulf Coast and Gulf of Mexico regions as part of our efforts to high grade our asset portfolio. In June 2008, we also acquired interests in domestic natural gas and oil properties in the Onshore Western region for approximately $43 million. These transactions, together with the Peoples Energy Production Company (Peoples) acquisition in the third quarter of 2007, increased the onshore U.S. weighting of our inventory of future capital projects and are expected to reduce our per-unit lease operating expenses as well as increase our future production growth rate.

For a more detailed discussion of our operations, refer to our Annual Report on Form 10-K. For a more detailed discussion of liquidity and capital resources related matters, see below.

Table of Contents

Segment Results

We have two core operating business segments, Pipelines and Exploration and Production. We also have a Marketing segment that markets our natural gas and oil production and manages our legacy trading activities and a Power segment that has interests in assets in South America and Asia. Our segments are managed separately, provide a variety of energy products and services, and require different technology and marketing strategies. Our corporate activities include our general and administrative functions, as well as other miscellaneous businesses, contracts and assets all of which are immaterial.

Our management uses earnings before interest expense and income taxes (EBIT) as a measure to assess the operating results and effectiveness of our business segments, which consist of both consolidated businesses and investments in unconsolidated affiliates. We believe EBIT is useful to investors because it allows them to evaluate more effectively our operating performance using the same performance measure analyzed internally by our management. We define EBIT as net income (loss) adjusted for (i) items that do not impact our income or loss from continuing operations, such as discontinued operations, (ii) income taxes and (iii) interest and debt expense. We exclude interest and debt expense from this measure so that investors may evaluate our operating results without regard to our financing methods or capital structure. EBIT may not be comparable to measurements used by other companies. Additionally, EBIT should be considered in conjunction with net income and other performance measures such as operating income and operating cash flows.

Below is a reconciliation of our EBIT (by segment) to our consolidated net income for the periods ended June 30:

	Quarters Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(In millions)			
Segment				
Pipelines	$ 295	$ 318	$ 676	$ 682
Exploration and Production	304	235	546	414
Marketing	(153)	5	(213)	(130)
Power	12	16	10	34
Segment EBIT	458	574	1,019	1,000
Corporate and other	41	(104)	80	(314)
Consolidated EBIT	499	470	1,099	686
Interest and debt expense	(221)	(231)	(454)	(514)
Income taxes	(87)	(70)	(235)	(51)
Income from continuing operations	191	169	410	121
Discontinued operations, net of income taxes		(3)		674
Net income	$ 191	$ 166	$ 410	$ 795

Table of Contents

Pipelines Segment

Operating Results. Below are the operating results for our Pipelines segment as well as a discussion of factors impacting EBIT, or that could potentially impact EBIT in future periods.

	Quarters Ended June 30, 2008	Quarters Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
	(In millions, except volume amounts)			
Operating revenues	$ 646	$ 614	$ 1,366	$ 1,258
Operating expenses	(383)	(338)	(746)	(658)
Operating income	263	276	620	600
Other income	40	42	73	82
EBIT before minority interest	303	318	693	682
Minority interest	(8)		(17)	
EBIT	$ 295	$ 318	$ 676	$ 682
Throughput volumes (BBtu/d)[1]	17,981	17,161	18,652	17,597

[1] Throughput volumes include volumes associated with our proportionate share of unconsolidated affiliates.

	Quarter Ended June 30, 2008 Variance Revenue Impact	Expense Impact	Other Impact	EBIT Impact	Six Months Ended June 30, 2008 Variance Revenue Impact	Expense Impact	Other Impact	EBIT Impact
	Favorable/(Unfavorable) (In millions)							
Expansions	$ 20	$ (5)	$ 2	$ 17	$ 45	$ (12)	$ 1	$ 34
Reservation and usage revenues	5			5	15			15
Gas not used in operations and revaluations	11	(16)		(5)	19	(12)		7
Bankruptcy settlements		1		1	30	1		31
Operating and general and administrative expenses		(19)		(19)		(30)		(30)

Gain/loss on long-lived assets		(3)		(3)		(26)		(26)
Equity earnings from Citrus			(3)	(3)			(12)	(12)
Minority interest			(8)	(8)			(17)	(17)
Other[1]	(4)	(3)	(1)	(8)	(1)	(9)	2	(8)
Total impact on EBIT	$ 32	$ (45)	$ (10)	$ (23)	$ 108	$ (88)	$ (26)	$ (6)

[1] Consists of individually insignificant items on several of our pipeline systems.

Expansions. In 2008, we benefited from increased reservation revenues and throughput volumes due to projects placed in service including the Wyoming Interstate Company, Ltd. (WIC) Kanda lateral project in January 2008, Phase II of the Cypress project in May 2008, and various projects placed in service throughout 2007 including Phase I of the Cypress project, the Louisiana Deepwater Link project, the Triple-T extension project and the Northeast ConneXion-New England project.

We have continued to make progress on and grow our significant backlog of expansion projects to $8 billion. El Paso s commGN INCOME AND OTHER TAX CONSEQUENCES TO YOU, IN LIGHT OF YOUR PARTICULAR INVESTMENT OR TAX CIRCUMSTANCES, OF ACQUIRING, HOLDING, AND DISPOSING OF OUR COMMON STOCK.

Taxation of the Company

We have elected to be taxed as a REIT under the Internal Revenue Code, commencing with our initial taxable year ending December 31, 2004. We believe that we are organized and operate in a manner that will allow us to continue to qualify for taxation as a REIT under the Internal Revenue.

The law firm of Clifford Chance US LLP has acted as our tax counsel since our initial public offering. We expect to receive the opinion of Clifford Chance US LLP to the effect that commencing with our taxable year ended December 31, 2004, we have been organized and operated in conformity with the requirements for qualification and taxation as a REIT under the Internal Revenue Code, and our current and proposed method of operation will enable us to continue to meet the requirements for qualification and taxation as a REIT under the Internal Revenue Code. It must be emphasized that the opinion of Clifford Chance US LLP will be based on various assumptions relating to our organization and operation, including that all factual representations and statements set forth in all relevant documents, records and instruments are true and correct, all actions described in this prospectus are completed in a timely fashion and that we will at all times operate in accordance with the method of operation described in our organizational documents and this prospectus, and is conditioned upon factual representations and covenants made by our management and affiliated entities regarding our organization, assets, the present and future conduct of our business operations, the fair market value of our investments in taxable REIT subsidiaries and other items regarding our ability to meet the various requirements for qualification as a REIT, and assumes that such representations and covenants are accurate and complete and that we will take no action inconsistent with our qualification as a REIT. While we believe that we are organized and intend to operate so that we will continue to qualify as a REIT, given the highly complex nature of the rules governing REITs, the ongoing importance of factual determinations, and the possibility of future changes in our circumstances, no assurance can be given by Clifford Chance US LLP or us that we will so qualify for any particular year. Clifford Chance US LLP will have no obligation to advise us or the holders of our common stock of any subsequent change in the matters stated, represented or assumed, or of any subsequent change in the applicable law. You should be aware that opinions of counsel are not binding on the IRS, and no assurance can be given that the IRS will not challenge the conclusions set forth in such opinions.

Qualification and taxation as a REIT depends on our ability to meet, on a continuing basis, through actual operating results, distribution levels, and diversity of stock ownership, various qualification requirements imposed upon REITs by the Internal Revenue Code, the compliance with which will not be reviewed by Clifford Chance US LLP. Our ability to qualify as a REIT also requires that we satisfy certain asset tests, some of which depend upon the fair market values of assets directly or indirectly owned by us. Such values may not be susceptible to a precise determination. Accordingly, no assurance can be given that the actual results of our operations for any taxable year will satisfy such requirements for qualification and taxation as a REIT.

Taxation of REITs in General

As indicated above, our qualification and taxation as a REIT depend upon our ability to meet, on a continuing basis, various qualification requirements imposed upon REITs by the Internal Revenue Code. The material qualification requirements are summarized below under " Requirements for Qualification General."

While we intend to operate so that we qualify as a REIT, no assurance can be given that the IRS will not challenge our qualification as a REIT, or that we will be able to operate in accordance with the REIT requirements in the future. See " Failure to Qualify."

Provided that we qualify as a REIT, we will generally be entitled to a deduction for dividends that we pay and therefore will not be subject to U.S. federal corporate income tax on our net income that is currently distributed to our stockholders. This treatment substantially eliminates the "double taxation" at the corporate and stockholder levels that results generally from investment in a corporation. Rather, income generated by a REIT generally is taxed only at the stockholder level upon a distribution of dividends by the REIT.

For the tax years through 2008, stockholders who are individual U.S. stockholders (as defined below) are taxed on corporate dividends at a maximum U.S. federal income tax rate of 15% (the same as long-term capital gains), thereby substantially reducing, though not completely eliminating, the double taxation that has historically applied to corporate dividends. With limited exceptions, however, dividends received by individual U.S. stockholders from us or from other entities that are taxed as REITs will continue to be taxed at rates applicable to ordinary income, which will be as high as 35% through 2010.

Net operating losses, foreign tax credits and other tax attributes of a REIT generally do not pass through to the stockholders of the REIT, subject to special rules for certain items such as capital gains recognized by REITs. See " Taxation of Stockholders."

If we qualify as a REIT, we will nonetheless be subject to U.S. federal tax in the following circumstances:

- We will be taxed at regular corporate rates on any undistributed income, including undistributed net capital gains.

- We may be subject to the "alternative minimum tax" on our items of tax preference, if any.

- If we have net income from prohibited transactions, which are, in general, sales or other dispositions of property held as inventory or primarily for sale to customers in the ordinary course of business, other than foreclosure property, such income will be subject to a 100% tax. See " Prohibited Transactions," and " Foreclosure Property," below.

- If we elect to treat property that we acquire in connection with a foreclosure of a mortgage loan or certain leasehold as "foreclosure property," we may thereby avoid (a) the 100% tax on gain from a resale of that property (if the sale would otherwise constitute a prohibited transaction), and (b) the inclusion of any income from such property not qualifying for purposes of the REIT gross income tests discussed below, but the income from the sale or operation of the property may be subject to corporate income tax at the highest applicable rate (currently 35%).

- If we fail to satisfy the 75% gross income test or the 95% gross income test discussed below, but nonetheless maintain our qualification as a REIT because certain other requirements are met, we will be subject to a tax equal to the greater of (i) the amount by which 75% of our gross income exceeds the amount qualifying under the 75% gross income test described below, and (ii) the amount by which 95% (90% for taxable years beginning before January 1, 2005) of our gross income exceeds the amount qualifying under the 95% gross income test described below, multiplied by a fraction intended to reflect our profitability.

Beginning with our tax year ending December 31, 2005, if we fail to satisfy any of the REIT asset tests, as described below, by larger than a de minimis amount, but our failure is due to reasonable cause and not due to willful neglect and we nonetheless maintain our REIT qualification because of specified cure provisions, we will be required to pay a tax equal to the greater of $50,000 or 35% of the net income generated by the non-qualifying assets during the period in which we failed to satisfy the asset tests.

Beginning with our tax year ended December 31, 2005, if we fail to satisfy any provision of the Code that would result in our failure to qualify as a REIT (other than a gross income or asset test requirement) and that violation is due to reasonable cause and not due to willful neglect, we may maintain our REIT qualification, but we will be required to pay a penalty of $50,000 for each such failure.

If we fail to distribute during each calendar year at least the sum of (a) 85% of our REIT ordinary income for such year, (b) 95% of our REIT capital gain net income for such year and (c) any undistributed taxable income from prior periods, or the "required distribution," we will be subject to a 4% excise tax on the excess of the required distribution over the sum of (i) the amounts actually distributed (taking into account excess distributions from prior years), plus (ii) retained amounts on which income tax is paid at the corporate level.

We may be required to pay monetary penalties to the IRS in certain circumstances, including if we fail to meet record-keeping requirements intended to monitor our compliance with rules relating to the composition of our stockholders, as described below in " Requirements for Qualification General."

A 100% excise tax may be imposed on some items of income and expense that are directly or constructively paid between us, our tenants and/or our "taxable REIT subsidiary" (as described below) if and to the extent that the IRS successfully adjusts the reported amounts of these items.

If we acquire appreciated assets from a corporation that is not a REIT (*i.e.*, a corporation taxable under subchapter C of the Internal Revenue Code) in a transaction in which the adjusted tax basis of the assets in our hands is determined by reference to the adjusted tax basis of the assets in the hands of the subchapter C corporation, we may be subject to tax on such appreciation at the highest corporate income tax rate then applicable to the extent we subsequently recognize gain on a disposition of such assets during the ten-year period following their acquisition from the subchapter C corporation. The results described in this paragraph assume that the subchapter C corporation will not elect in lieu of this treatment to be subject to an immediate tax when the asset is acquired.

We may elect to retain and pay income tax on our net long-term capital gain. In that case, a stockholder would include its proportionate share of our undistributed long-term capital gain (to the extent we make a timely designation of such gain to the stockholder) in its income, we would be deemed to have paid the tax that we paid on such gain, and would be allowed a credit for its proportionate share of the tax deemed to have been paid, and an adjustment would be made to increase the stockholders' basis in our common stock.

We may have subsidiaries or own interests in other lower-tier entities that are subchapter C corporations, including our taxable REIT subsidiary, the earnings of which will be subject to U.S. federal corporate income tax.

In addition, we and our subsidiaries may be subject to a variety of taxes other than U.S. federal income tax, including payroll taxes and state, local, and foreign income, property and other taxes on our assets and operations. We could also be subject to tax in situations and on transactions not presently contemplated.

Requirements for Qualification General

The Internal Revenue Code defines a REIT as a corporation, trust or association:

(1) that is managed by one or more trustees or directors;

(2) the beneficial ownership of which is evidenced by transferable shares, or by transferable certificates of beneficial interest;

(3) that would be taxable as a domestic corporation but for the special Internal Revenue Code provisions applicable to REITs;

(4) that is neither a financial institution nor an insurance company subject to specific provisions of the Internal Revenue Code;

(5) the beneficial ownership of which is held by 100 or more persons;

(6) in which, during the last half of each taxable year, not more than 50% in value of the outstanding stock is owned, directly or indirectly, by five or fewer "individuals" (as defined in the Internal Revenue Code to include specified entities);

(7) which meets other tests described below, including with respect to the nature of its income and assets and the amount of its distributions; and

(8) that makes an election to be a REIT for the current taxable year or has made such an election for a previous taxable year that has not been terminated or revoked.

The Internal Revenue Code provides that conditions (1) through (4) must be met during the entire taxable year, and that condition (5) must be met during at least 335 days of a taxable year of 12 months, or during a proportionate part of a shorter taxable year. Conditions (5) and (6) do not need to be satisfied for the first taxable year for which an election to become a REIT has been made. Our charter provides restrictions regarding the ownership and transfer of our shares, which are intended to assist us in satisfying the share ownership requirements described in conditions (5) and (6) above. For purposes of condition (6), an "individual" generally includes a supplemental unemployment compensation benefit plan, a private foundation, or a portion of a trust permanently set aside or used exclusively for charitable purposes, but does not include a qualified pension plan or profit sharing trust.

To monitor compliance with the share ownership requirements, we are generally required to maintain records regarding the actual ownership of our shares. To do so, we must demand written statements each year from the record holders of significant percentages of our stock in which the record holders are to disclose the actual owners of the shares, which are the persons required to include in gross income the dividends paid by us. A list of those persons failing or refusing to comply with this demand must be maintained as part of our records. Failure by us to comply with these record-keeping requirements could subject us to monetary penalties. If we satisfy these requirements and have no reason to know that condition (6) is not satisfied, we will be deemed to have satisfied such condition. A stockholder that fails or refuses to comply with the demand is required by Treasury regulations to submit a statement with its tax return disclosing the actual ownership of the shares and other information.

In addition, a corporation generally may not elect to become a REIT unless its taxable year is the calendar year. We satisfy this requirement.

Effect of Subsidiary Entities

Ownership of Partnership Interests. In the case of a REIT that is a partner in a partnership, Treasury regulations provide that the REIT is deemed to own its proportionate share of the partnership's assets, and to earn its proportionate share of the partnership's gross income based on its pro rata share of capital interests in the partnership, for purposes of the asset and gross income tests applicable to REITs as described below. In addition, the assets and gross income of the partnership generally are deemed to retain the same character in the hands of the REIT. Thus, our proportionate share, based upon our percentage capital interest, of the assets and items of income of partnerships in which we own an equity interest (including our interest in our operating partnership and its equity interests in lower-tier partnerships), is treated as assets and items of income of our company for purposes of applying the REIT requirements described below. Consequently, to the extent that we directly or indirectly hold a preferred or other equity interest in a partnership, the partnership's assets and operations may affect our ability to qualify as a REIT, even though we may have no control, or only limited influence, over the partnership. A summary of certain rules governing the U.S. federal income taxation of partnerships and their partners is provided below in " Tax Aspects of Investments in Partnerships."

Disregarded Subsidiaries. If a REIT owns a corporate subsidiary that is a "qualified REIT subsidiary," that subsidiary is disregarded for U.S. federal income tax purposes, and all assets, liabilities and items of income, deduction and credit of the subsidiary are treated as assets, liabilities and items of income, deduction and credit of the REIT itself, including for purposes of the gross income and asset tests applicable to REITs as summarized below. A qualified REIT subsidiary is any corporation, other than a "taxable REIT subsidiary" (as described below), that is wholly owned by a REIT, or by other disregarded subsidiaries, or by a combination of the two. Single member limited liability companies that are wholly owned by a REIT are also generally disregarded as separate entities for U.S. federal income tax purposes, including for purposes of the REIT gross income and asset tests. Disregarded subsidiaries, along with partnerships in which we hold an equity interest, are sometimes referred to herein as "pass-through subsidiaries."

In the event that a disregarded subsidiary ceases to be wholly owned by us for example, if any equity interest in the subsidiary is acquired by a person other than us or another disregarded subsidiary of us the subsidiary's separate existence would no longer be disregarded for U.S. federal income tax purposes. Instead, it would have multiple owners and would be treated as either a partnership or a taxable corporation. Such an event could, depending on the circumstances, adversely affect our ability to satisfy the various asset and gross income tests applicable to REITs, including the requirement that REITs generally may not own, directly or indirectly, more than 10% of the value or voting power of the outstanding securities of another corporation. See " Asset Tests" and " Gross Income Tests."

Taxable Subsidiaries. A REIT, in general, may jointly elect with a subsidiary corporation, whether or not wholly owned, to treat the subsidiary corporation as a taxable REIT subsidiary. The separate existence of a taxable REIT subsidiary or other taxable corporation, unlike a disregarded subsidiary as discussed above, is not ignored for U.S. federal income tax purposes. Accordingly, such an entity would generally be subject to corporate income tax on its earnings, which may reduce the cash flow generated by us and our subsidiaries in the aggregate, and our ability to make distributions to our stockholders.

A REIT is not treated as holding the assets of a taxable subsidiary corporation or as receiving any income that the subsidiary earns. Rather, the stock issued by the subsidiary is an asset in the hands of the REIT, and the REIT recognizes as income the dividends, if any, that it receives from the subsidiary. This treatment can affect the gross income and asset test calculations that apply to the REIT, as described below. Because a parent REIT does not include the assets and income of such subsidiary corporations in determining the parent's compliance with the REIT requirements, such entities may be used by the parent REIT to undertake indirectly activities that the REIT rules might otherwise preclude it from doing directly or through pass-through subsidiaries (for example, activities that give rise to certain categories of income such as management fees or foreign currency gains).

Certain restrictions imposed on taxable REIT subsidiaries are intended to ensure that such entities will be subject to appropriate levels of U.S. federal income taxation. First, a taxable REIT subsidiary may not deduct interest payments made in any year to an affiliated REIT to the extent that such payments exceed, generally, 50% of the taxable REIT subsidiary's adjusted taxable income for that year (although the taxable REIT subsidiary may carry forward to, and deduct in, a succeeding year the disallowed interest if the 50% test is satisfied in that year). In addition, if amounts are paid to a REIT or deducted by a taxable REIT subsidiary due to transactions between a REIT, its tenants and/or a taxable REIT subsidiary, that exceed the amount that would be paid to or deducted by a party in an arm's-length transaction, the REIT generally will be subject to an excise tax equal to 100% of such excess. We and one of our corporate subsidiaries, Extra Space Management Inc., elected for that subsidiary to be treated as a taxable REIT subsidiary for U.S. federal income tax purposes.

Gross Income Tests

In order to maintain qualification as a REIT, we annually must satisfy two gross income tests. First, at least 75% of our gross income for each taxable year, excluding gross income from sales of inventory or dealer property in "prohibited transactions," must be derived from investments relating to real property or mortgages on real property, including "rents from real property," dividends received from other REITs, interest income derived from mortgage loans secured by real property (including certain types of mortgage-backed securities), and gains from the sale of real estate assets, as well as income from certain kinds of temporary investments. Second, at least 95% of our gross income in each taxable year, excluding gross income from prohibited transactions, must be derived from some combination of income that qualifies under the 75% income test described above, as well as other dividends, interest, and gain from the sale or disposition of stock or securities, which need not have any relation to real property.

Rents received by us will qualify as "rents from real property" in satisfying the gross income tests described above, only if several conditions are met, including the following. The rent must not be based in whole or in part on the income or profits of any person. However, an amount will not be excluded from rents from real property solely by being based on a fixed percentage or percentages of sales or if it is based on the net income of a tenant which derives substantially all of its income with respect to such property from subleasing of substantially all of such property, to the extent that the rents paid by the sublessees would qualify as rents from real property, if earned directly by us. If rent is partly attributable to personal property leased in connection with a lease of real property, the portion of the total rent that is attributable to the personal property will not qualify as "rents from real property" unless it constitutes 15% or less of the total rent received under the lease. Moreover, for rents received to qualify as "rents from real property," we generally must not operate or manage the property or furnish or render certain services to the tenants of such property, other than through an "independent contractor" who is adequately compensated and from which we derive no income or through a taxable REIT subsidiary, as discussed below. We are permitted, however, to perform services that are "usually or customarily rendered" in connection with the rental of space for occupancy only and are not otherwise considered rendered to the occupant of the property. In addition, we may directly or indirectly provide non-customary services to tenants of our properties without disqualifying all of the rent from the property if the payment for such services does not exceed 1% of the total gross income from the property. In such a case, only the amounts for non-customary services are not treated as rents from real property. The rest of the rent will be qualifying income. For purposes of this test, the income received from such non-customary services is deemed to be at least 150% of the direct cost of providing the services. Moreover, we are permitted to provide services to tenants or others through a taxable REIT subsidiary without disqualifying the rental income received from tenants for purposes of the REIT income tests. Also, rental income will qualify as rents from real property only to the extent that we do not directly or constructively own, (i) in the case of any lessee which is a corporation, stock possessing 10% or more of the total combined voting power of all classes of stock entitled to vote, or 10% or more of the total value of shares of all classes of stock of such lessee, or (ii) in the case of any lessee which is not a corporation, an interest of 10% or more in the assets or net profits of such lessee. However, rental payments from a taxable REIT subsidiary will qualify as rents from real property even if we own more than 10% of the combined voting power of the taxable REIT subsidiary if at least 90% of the property is leased to unrelated tenants and the rent paid by the taxable REIT subsidiary is substantially comparable to the rent paid by the unrelated tenants for comparable space.

Unless we determine that the resulting nonqualifying income under any of the following situations, taken together with all other nonqualifying income earned by us in the taxable year, will not jeopardize our qualification as a REIT, we do not and do not intend to:

- charge rent for any property that is based in whole or in part on the income or profits of any person, except by reason of being based on a fixed percentage or percentages of receipts or sales, as described above;

- rent any property to a related party tenant, including a taxable REIT subsidiary, unless the rent from the lease to the taxable REIT subsidiary would qualify for the special exception from the related party tenant rule applicable to certain leases with a taxable REIT subsidiary;

- derive rental income attributable to personal property other than personal property leased in connection with the lease of real property, the amount of which is less than 15% of the total rent received under the lease; or

- directly perform services considered to be noncustomary or rendered to the occupant of the property.

We may indirectly receive distributions from taxable REIT subsidiaries or other corporations that are not REITs or qualified REIT subsidiaries. These distributions will be classified as dividend income to the extent of the earnings and profits of the distributing corporation. Such distributions will generally constitute qualifying income for purposes of the 95% gross income test, but not under the 75% gross income test. Any dividends received by us from a REIT will be qualifying income in our hands for purposes of both the 95% and 75% gross income tests.

Interest income constitutes qualifying mortgage interest for purposes of the 75% gross income test (as described above) to the extent that the obligation is secured by a mortgage on real property. If we receive interest income with respect to a mortgage loan that is secured by both real property and other property, and the highest principal amount of the loan outstanding during a taxable year exceeds the fair market value of the real property on the date that we acquired or originated the mortgage loan, the interest income will be apportioned between the real property and the other property, and our income from the arrangement will qualify for purposes of the 75% gross income test only to the extent that the interest is allocable to the real property. Even if a loan is not secured by real property or is undersecured, the income that it generates may nonetheless qualify for purposes of the 95% gross income test.

To the extent that the terms of a mortgage loan provide for contingent interest that is based on the cash proceeds realized upon the sale of the property securing the loan (a "shared appreciation provision"), income attributable to the participation feature will be treated as gain from sale of the underlying property, which generally will be qualifying income for purposes of both the 75% and 95% gross income tests, provided that the property is not inventory or primarily held for sale to customers in the ordinary course of business in the hands of the borrower or us.

To the extent that we derive interest income from a loan where all or a portion of the amount of interest payable is contingent, such income generally will qualify for purposes of the gross income tests only if it is based upon the gross receipts or sales, and not the net income or profits of any person. This limitation does not apply, however, to a mortgage loan where the borrower derives substantially all of its income from the property from the leasing of substantially all of its interest in the property to tenants, to the extent that the rental income derived by the borrower would qualify as rents from real property had it been earned directly by us.

If we fail to satisfy one or both of the 75% or 95% gross income tests for any taxable year, we may still qualify as a REIT for the year if we are entitled to relief under applicable provisions of the Internal Revenue Code. These relief provisions will generally be available if the failure of our company to meet these tests was due to reasonable cause and not due to willful neglect and, following the identification of such failure, we set forth a description of each item of our gross income that satisfies the gross income tests in a schedule for the taxable year filed in accordance with regulations prescribed by the Treasury department. It is not possible to state whether we would be entitled to the benefit of these relief provisions in all circumstances. If these relief provisions are inapplicable to a particular set of circumstances involving us, we will not qualify as a REIT. As discussed above under " Taxation of REITs in General," even where these relief provisions apply, a tax would be imposed upon certain amounts by which we fail to satisfy the particular gross income test.

Asset Tests

At the close of each calendar quarter we must also satisfy four tests relating to the nature of our assets. First, at least 75% of the value of our total assets must be represented by some combination of "real estate assets," cash, cash items, U.S. government securities, and, under some circumstances, stock or debt instruments purchased with new capital. For this purpose, real estate assets include interests in real property, such as land, buildings, leasehold interests in real property, stock of other corporations that qualify as REITs, and certain kinds of mortgage-backed securities and mortgage loans. Assets that do not qualify for purposes of the 75% test are subject to the additional asset tests described below.

The second asset test is that the value of any one issuer's securities owned by us may not exceed 5% of the value of our gross assets. Third, we may not own more than 10% of any one issuer's outstanding securities, as measured by either voting power or value. Fourth, the aggregate value of all securities of taxable REIT subsidiaries held by us may not exceed 20% of the value of our gross assets.

The 5% and 10% asset tests do not apply to securities of taxable REIT subsidiaries, qualified REIT subsidiaries or securities that are "real estate assets" for purposes of the 75% gross asset test described above.

The 10% value test does not apply to certain "straight debt" and other excluded securities, as described in the Code including, but not limited to, any loan to an individual or estate, any obligation to pay rents from real property and any security issued by a REIT. In addition, (a) a REIT's interest as a partner in a partnership is not considered a security for purposes of applying the 10% value test to securities issued by the partnership; (b) any debt instrument issued by a partnership (other than straight debt or another excluded security) will not be considered a security issued by the partnership if at least 75% of the partnership's gross income is derived from sources that would qualify for the 75% REIT gross income test; and (c) any debt instrument issued by a partnership (other than straight debt or another excluded security) will not be considered a security issued by the partnership to the extent of the REIT's interest as a partner in the partnership. In general, straight debt is defined as a written, unconditional promise to pay on demand or at a specific date a fixed principal amount, and the interest rate and payment dates on the debt must not be contingent on profits or the discretion of the debtor. In addition, straight debt may not contain a convertibility feature.

After initially meeting the asset tests at the close of any quarter, we will not lose our qualification as a REIT for failure to satisfy the asset tests at the end of a later quarter solely by reason of changes in asset values. If we fail to satisfy the asset tests because we acquire securities during a quarter, we can cure this failure by disposing of the non-qualifying assets within 30 days after the close of that quarter. If we fail the 5% asset test or the 10% asset test at the end of any quarter, and the such failure is not cured within 30 days thereafter, we may dispose of sufficient assets (generally, within six months after the last day of the quarter in which our identification of the failure to satisfy those asset tests occurred) to cure the violation, provided that the non-permitted assets do not exceed the lesser of 1% of our assets at the end of the relevant quarter or $10,000,000. If we fail any of the other asset tests, or our failure of the 5% and 10% asset tests is in excess of this amount, as long as the failure was due to reasonable cause and not willful neglect, we are permitted to avoid disqualification as a REIT, after the thirty day cure period, by taking steps including the disposition of sufficient assets to meet the asset tests (generally within six months after the last day of the quarter in which our identification of the failure to satisfy the REIT asset test occurred), and paying a tax equal to the greater of $50,000 or 35% of the net income generated by the non-qualifying assets during the period in which we failed to satisfy the relevant asset test.

We believe that our holdings of securities and other assets will comply with the foregoing REIT asset requirements, and we intend to monitor compliance with such tests on an ongoing basis. However, the values of some of our assets, including the securities of our taxable REIT subsidiary, may not be precisely valued, and values are subject to change in the future. Furthermore, the proper classification of an instrument as debt or equity for U.S. federal income tax purposes may be uncertain in some circumstances, which could affect the application of the REIT asset tests. Accordingly, there can be no assurance that the IRS will not contend that our assets do not meet the requirements of the REIT asset tests.

Annual Distribution Requirements

In order to qualify as a REIT, we are required to distribute dividends, other than capital gain dividends, to our stockholders in an amount at least equal to:

(a) the sum of:

- 90% of our "REIT taxable income" (computed without regard to our deduction for dividends paid and our net capital gains), and
- 90% of the net income, if any (after tax), from foreclosure property (as described below), minus

(b) the sum of specified items of non-cash income that exceeds a percentage of our income.

These distributions must be paid in the taxable year to which they relate, or in the following taxable year if such distributions are declared in October, November or December of the taxable year, payable to stockholders of record on a specified date in any such month, and are actually paid before the end of January of the following year. Such distributions are treated as both paid by us and received by each stockholder on December 31 of the year in which they are declared. In addition, at our election, a distribution for a taxable year may be declared before we timely file our tax return for the year and paid with or before the first regular dividend payment after such declaration, provided such payment is made during the 12-month period following the close of such taxable year. These distributions are taxable to our stockholders in the year in which paid, even though the distributions relate to our prior taxable year for purposes of the 90% distribution requirement.

In order for distributions to be counted towards our distribution requirement, and provide us with a tax deduction, they must not be "preferential dividends." A dividend is not a preferential dividend if it is pro rata among all outstanding shares of stock within a particular class, and is in accordance with the preferences among different classes of stock as set forth in the organizational documents.

To the extent that we distribute less than 100% of our net taxable income, we will be subject to U.S. federal income tax at ordinary corporate tax rates on the retained portion. In addition, we may elect to retain, rather than distribute, our net long-term capital gains and pay tax on such gains. In this case, we could elect to have our stockholders include their proportionate share of such undistributed long-term capital gains in income and receive a corresponding credit for their proportionate share of the tax paid by us. Our stockholders would then increase the adjusted basis of their stock in us by the difference between the designated amounts included in their long-term capital gains and the tax deemed paid with respect to their proportionate shares.

If we fail to distribute during each calendar year at least the sum of (1) 85% of our REIT ordinary income for such year, (2) 95% of our REIT capital gain net income for such year and (3) any undistributed taxable income from prior periods, we will be subject to a 4% excise tax on the excess of such required distribution over the sum of (A) the amounts actually distributed (taking into account excess distributions from prior periods) and (B) the amounts of income retained on which we have paid corporate income tax. We intend to make timely distributions so that we are not subject to the 4% excise tax.

It is possible that we, from time to time, may not have sufficient cash to meet the distribution requirements due to timing differences between (1) the actual receipt of cash, including receipt of distributions from our subsidiaries and (2) the inclusion of items in income by us for U.S. federal income tax purposes. Potential sources of non-cash taxable income include loans or mortgage-backed securities held by us as assets that are issued at a discount and require the accrual of taxable interest income in advance of our receipt in cash, loans on which the borrower is permitted to defer cash payments of interest and distressed loans on which we may be required to accrue taxable interest income even though the borrower is unable to make current interest payments in cash. In the event that such timing differences occur, in order to meet the distribution requirements, it might be necessary to arrange for short-term, or possibly long-term, borrowings, or to pay dividends in the form of taxable in-kind distributions of property.

We may be able to rectify a failure to meet the distribution requirements for a year by paying "deficiency dividends" to stockholders in a later year, which may be included in our deduction for dividends paid for the earlier year. In this case, we may be able to avoid losing our REIT qualification or being taxed on amounts distributed as deficiency dividends. However, we will be required to pay interest and a penalty based on the amount of any deduction taken for deficiency dividends.

Failure to Qualify

If we fail to qualify for taxation as a REIT in any taxable year, and the relief provisions of the Internal Revenue Code do not apply, we will be subject to tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates. Distributions to our stockholders in any year in which we are not a REIT will not be deductible by us, nor will they be required to be made. In this situation, to the extent of current and accumulated earnings and profits, and, subject to limitations of the Internal Revenue Code, distributions to our individual U.S. stockholders (as defined below) will generally be taxable at a maximum rate of 15%, and our corporate U.S. stockholders may be eligible for the dividends received deduction. Unless we are entitled to relief under specific statutory provisions, we will also be disqualified from re-electing to be taxed as a REIT for the four taxable years following a year during which qualification was lost. It is not possible to state whether, in all circumstances, we will be entitled to this statutory relief.

Prohibited Transactions

Net income derived from a "prohibited transaction" is subject to a 100% tax. A "prohibited transaction" generally includes a sale or other disposition of property (other than foreclosure property) that is held as inventory or primarily for sale to customers in the ordinary course of a trade or business by a REIT, by a lower-tier partnership in which the REIT holds an equity interest or by a borrower that has issued a shared appreciation mortgage or similar debt instrument to the REIT. We intend to hold our properties for investment with a view to long-term appreciation, to engage in the business of owning and operating properties and to make sales of properties that are consistent with our investment objectives. However, whether property is held an inventory or primarily for sale to tenants in the ordinary course of a trade or business depends on the particular facts and circumstances. No assurance can be given that any particular property in which we hold a direct or indirect interest will not be treated as property held for sale to tenants, or that certain safe-harbor provisions of the Internal Revenue Code that prevent such treatment will apply. The 100% tax will not apply to gains from the sale of property that is held through a taxable REIT subsidiary or other taxable corporation, although such income will be subject to tax in the hands of the corporation at regular corporate income tax rates.

Foreclosure Property

Foreclosure property is real property and any personal property incident to such real property (1) that is acquired by a REIT as a result of the REIT having bid in the property at foreclosure, or having otherwise reduced the property to ownership or possession by agreement or process of law, after there was a default (or default was imminent) on a lease of the property or a mortgage loan held by the REIT and secured by the property, (2) for which the related loan or lease was acquired by the REIT at a time when default was not imminent or anticipated and (3) for which such REIT makes a proper election to treat the property as foreclosure property. REITs generally are subject to tax at the maximum corporate rate (currently 35%) on any net income from foreclosure property, including any gain from the disposition of the foreclosure property, other than income that would otherwise be qualifying income for purposes of the 75% gross income test. Any gain from the sale of property for which a foreclosure property election has been made will not be subject to the 100% tax on gains from prohibited transactions described above, even if the gain would otherwise be treated as a prohibited transaction. We do not anticipate that we will receive any income from foreclosure property that is not qualifying income for purposes of the 75% gross income test, but, if we do receive any such income, we intend to make an election to treat the related property as foreclosure property.

Hedging Transactions

We may enter into hedging transactions with respect to one or more of our assets or liabilities. Hedging transactions could take a variety of forms, including interest rate swaps or cap agreements, options, futures contracts, forward rate agreements or similar financial instruments. Except to the extent provided by Treasury regulations, any income from a hedging transaction to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred by us to acquire or own real estate assets, which is clearly identified as such before the close of the day on which it was acquired, originated or entered into, including gain from the disposition of such a transaction, will not constitute gross income for purposes of the 95% gross income test (but generally will constitute non-qualifying gross income for purposes of the 75% income test). To the extent we enter into other types of hedging transactions, the income from those transactions is likely to be treated as non-qualifying income for purposes of both the 75% and 95% gross income tests. We intend to structure any hedging transactions in a manner that does not jeopardize our ability to qualify as a REIT.

Foreign Investments

To the extent that our company and our subsidiaries hold or acquire any investments and, accordingly, pay taxes in foreign countries, taxes paid by us in foreign jurisdictions may not be passed through to, or used by, our stockholders as a foreign tax credit or otherwise. Any foreign investments may also generate foreign currency gains and losses. Foreign currency gains are generally treated as income that does not qualify under the 95% or 75% gross income tests.

Tax Aspects of Investments in Partnerships

General

We may hold investments through entities that are classified as partnerships for U.S. federal income tax purposes, including our interest in our operating partnership and the equity interests in lower-tier partnerships. In general, partnerships are "pass-through" entities that are not subject to U.S. federal income tax. Rather, partners are allocated their proportionate shares of the items of income, gain, loss, deduction and credit of a partnership, and are subject to tax on these items without regard to whether the partners receive a distribution from the partnership. We will include in our income our proportionate share of these partnership items for purposes of the various REIT income tests, based on our capital interest in such partnership, and in the computation of our net taxable income. Moreover, for purposes of the REIT asset tests, we will include our proportionate share of assets held by subsidiary partnerships, based on our capital interest in such partnerships. See " Taxation of the Company Effect of Subsidiary Entities Ownership of Partnership Interests" above. Consequently, to the extent that we hold an equity interest in a partnership, the partnership's assets and operations may affect our ability to qualify as a REIT, even though we may have no control, or only limited influence, over the partnership.

Entity Classification

The investment by us in partnerships involves special tax considerations, including the possibility of a challenge by the IRS of the status of any of our subsidiary partnerships as a partnership, as opposed to an association taxable as a corporation, for U.S. federal income tax purposes. If any of these entities were treated as an association for U.S. federal income tax purposes, it would be taxable as a corporation and therefore could be subject to an entity-level tax on its income. In such a situation, the character of our assets and items of our gross income would change and could preclude us from satisfying the REIT asset tests (particularly the tests generally preventing a REIT from owning more than 10% of the voting securities, or more than 10% of the value of the securities, of a corporation) or the gross income tests as discussed in " Taxation of the Company Asset Tests" and " Income Tests" above, and in turn could prevent us from qualifying as a REIT. See " Taxation of the Company Failure to Qualify," above, for a discussion of the effect of our failure to meet these tests for a taxable year. In addition, any change in the status of any of our subsidiary partnerships for U.S. federal income tax purposes might be treated as a taxable event, in which case we could have taxable income that is subject to the REIT distribution requirements without receiving any cash.

Tax Allocations with Respect to Partnership Properties

Under the Internal Revenue Code and the Treasury regulations, income, gain, loss and deduction attributable to appreciated or depreciated property that is contributed to a partnership in exchange for an interest in the partnership must be allocated for tax purposes in a manner such that the contributing partner is charged with, or benefits from, the unrealized gain or unrealized loss associated with the property at the time of the contribution. The amount of the unrealized gain or unrealized loss is generally equal to the difference between the fair market value of the contributed property at the time of contribution, and the adjusted tax basis of such property at the time of contribution (a "book-tax difference"). Such allocations are solely for U.S. federal income tax purposes and do not affect the book capital accounts or other economic or legal arrangements among the partners.

To the extent that any of our subsidiary partnerships acquires appreciated (or depreciated) properties by way of capital contributions from its partners, allocations would need to be made in a manner consistent with these requirements. In connection with our initial public offering, appreciated property was contributed to our operating partnership by both us as a result of our contribution to the operating partnership of the Extra Space Storage membership interests contributed to us by the members of Extra Space Storage LLC, our predecessor, and by other partners of our operating partnership. As a result, partners, including us, in subsidiary partnerships, could be allocated greater or lesser amounts of depreciation and taxable income in respect of a partnership's properties than would be the case if all of the partnership's assets (including any contributed assets) had a tax basis equal to their fair market values at the time of the contributions. This could cause us to recognize, over a period of time, (1) lower amounts of depreciation deductions for U.S. federal income tax purposes than if all of the contributed properties were to have a tax basis equal to their fair market value at the time of their contribution to the operating partnership and (2) taxable income in excess of economic or book income as a result of a sale of a property, which might adversely affect our ability to comply with the REIT distribution requirements discussed above and result in our stockholders recognizing additional dividend income without an increase in distributions.

Taxation of Stockholders

Taxation of Taxable U.S. Stockholders

This section summarizes the taxation of U.S. stockholders that are not tax-exempt organizations. For these purposes, a U.S. stockholder is a beneficial owner of our common stock that for U.S. federal income tax purposes is:

- a citizen or resident of the United States;
- a corporation (including an entity treated as a corporation for U.S. federal income tax purposes) created or organized in or under the laws of the United States or of a political subdivision thereof (including the District of Columbia);
- an estate whose income is subject to U.S. federal income taxation regardless of its source; or
- any trust if (1) a U.S. court is able to exercise primary supervision over the administration of such trust and one or more U.S. persons have the authority to control all substantial decisions of the trust or (2) it has a valid election in place to be treated as a U.S. person.

If an entity or arrangement treated as a partnership for U.S. federal income tax purposes holds our stock, the U.S. federal income tax treatment of a partner generally will depend upon the status of the partner and the activities of the partnership. A partner of a partnership holding our common stock should consult its tax advisor regarding the U.S. federal income tax consequences to the partner of the acquisition, ownership and disposition of our stock by the partnership.

Distributions. Provided that we continue to qualify as a REIT, distributions made to our taxable U.S. stockholders out of our current and accumulated earnings and profits, and not designated as capital gain dividends, will generally be taken into account by them as ordinary dividend income and will not be eligible for the dividends received deduction for corporations. In determining the extent to which a distribution with respect to our common stock constitutes a dividend for U.S. federal income tax purposes, our earnings and profits will be allocated first to distributions with respect to our preferred stock, if any, and then to our common stock. Dividends received from REITs are generally not eligible to be taxed at the preferential qualified dividend income rates applicable to individual U.S. stockholders.

In addition, distributions from us that are designated as capital gain dividends will be taxed to U.S. stockholders as long-term capital gains, to the extent that they do not exceed the actual net capital gain of our company for the taxable year, without regard to the period for which the U.S. stockholder has held its stock. To the extent that we elect under the applicable provisions of the Internal Revenue Code to retain our net capital gains, U.S. stockholders will be treated as having received, for U.S. federal income tax purposes, our undistributed capital gains as well as a corresponding credit for taxes paid by us on such retained capital gains. U.S. stockholders will increase their adjusted tax basis in our common stock by the difference between their allocable share of such retained capital gain and their share of the tax paid by us. Corporate U.S. stockholders may be required to treat up to 20% of some capital gain dividends as ordinary income. Long-term capital gains are generally taxable at maximum U.S. federal income tax rates of 15% (through 2008) in the case of U.S. stockholders who are individuals, and 35% for corporations. Capital gains attributable to the sale of depreciable real property held for more than 12 months are subject to a 25% maximum U.S. federal income tax rate for individual U.S. stockholders to the extent of previously claimed depreciation deductions. Because many of our assets were contributed to us in a carryover basis transaction at the time of our formation, we may recognize capital gain on the sale of assets that is attributable to gain that was built into the asset at the time of formation.

Distributions in excess of our current and accumulated earnings and profits will not be taxable to a U.S. stockholder to the extent that they do not exceed the adjusted tax basis of the U.S. stockholder's shares in respect of which the distributions were made, but rather will reduce the adjusted tax basis of these shares. To the extent that such distributions exceed the adjusted tax basis of an individual U.S. stockholder's shares, they will be included in income as long-term capital gain, or short-term capital gain if the shares have been held for one year or less. In addition, any dividend declared by us in October, November or December of any year and payable to a U.S. stockholder of record on a specified date in any such month will be treated as both paid by us and received by the U.S. stockholder on December 31 of such year, provided that the dividend is actually paid by us before the end of January of the following calendar year. In addition, at our election, a distribution for a taxable year may be declared before we timely file our tax return for the year and paid with our before the first regular dividend payment after such declaration, provided such payment is made during the 12-month period following the close of the taxable year. These distributions are taxable to our stockholders in the year in which paid, even though the distributions relate to our prior taxable year for purpose of our 90% distribution requirement.

With respect to individual U.S. stockholders, we may elect to designate a portion of our distributions as "qualified dividend income." A portion of a distribution that is properly designated as qualified dividend income is taxable to individual U.S. stockholders as capital gain, provided that the U.S. stockholder has held the common stock with respect to which the distribution is made for more than 60 days during the 120-day period beginning on the date that is 60 days before the date on which such common stock became ex-dividend with respect to the relevant distribution. The maximum amount of our distributions eligible to be designated as qualified dividend income for a taxable year is equal to the sum of:

(a) the qualified dividend income received by us during such taxable year from non-REIT C corporations (including our taxable REIT subsidiaries);

(b) the excess of any "undistributed" REIT taxable income recognized during the immediately preceding year over the U.S. federal income tax paid by us with respect to such undistributed REIT taxable income; and

(c) the excess of any income recognized during the immediately preceding year attributable to the sale of a built-in-gain asset that was acquired in a carry-over basis transaction from a non-REIT C corporation over the U.S. federal income tax paid by us with respect to such built-in gain.

Generally, dividends that we receive will be treated as qualified dividend income for purposes of (a) above if the dividends are received from a domestic C corporation (other than a REIT or a regulated investment company) or a "qualifying foreign corporation" and specified holding period requirements and other requirements are met. A foreign C corporation (other than a "foreign personal holding company," a "foreign investment company," or "passive foreign investment company") will be a qualifying foreign corporation if it is incorporated in a possession of the United States, the corporation is eligible for benefits of an income tax treaty with the United States that the Secretary of Treasury determines is satisfactory, or the stock of the foreign corporation on which the dividend is paid is readily tradable on an established securities market in the United States. We do not expect that a significant portion of our distributions will consist of qualified dividend income.

To the extent that we have available net operating losses and capital losses carried forward from prior tax years, such losses may reduce the amount of distributions that must be made in order to comply with the REIT distribution requirements. See "Taxation of the Company Annual Distribution Requirements." Such losses, however, are not passed through to U.S. stockholders and do not offset income of U.S. stockholders from other sources, nor do they affect the character of any distributions that are actually made by us, which are generally subject to tax in the hands of U.S. stockholders to the extent that we have current or accumulated earnings and profits.

Dispositions of Our Common Stock. In general, a U.S. stockholder will realize gain or loss upon the sale, redemption or other taxable disposition of our common stock in an amount equal to the difference between the sum of the fair market value of any property and the amount of cash received in such disposition and the U.S. stockholder's adjusted tax basis in the common stock at the time of the disposition. In general, a U.S. stockholder's adjusted tax basis will equal the U.S. stockholder's acquisition cost, increased by the excess of net capital gains deemed distributed to the U.S. stockholder (discussed above) less tax deemed paid by it and reduced by return of capital distributions (as described above). In general, capital gains recognized by individuals and other non-corporate U.S. stockholders upon the sale or disposition of shares of our common stock will be subject to a maximum U.S. federal income tax rate of 15% for taxable years through 2008, if our common stock is held for more than 12 months, and will be taxed at ordinary income rates (of up to 35% through 2010) if our common stock is held for 12 months or less. Gains recognized by U.S. stockholders that are corporations are subject to U.S. federal income tax at a maximum rate of 35%, whether or not classified as long-term capital gains. The IRS has the authority to prescribe, but has not yet prescribed, regulations that would apply a capital gain tax rate of 25% (which is generally higher than the long-term capital gain tax rates for non-corporate holders) to a portion of capital gain realized by a non-corporate holder on the sale of REIT stock or depositary shares that would correspond to the REIT's "unrecaptured Section 1250 gain." Holders are urged to consult their tax advisors with respect to their capital gain tax liability. Capital losses recognized by a U.S. stockholder upon the disposition of our common stock are generally available only to offset capital gain income of the U.S. stockholder but not ordinary income (except in the case of individuals, who may offset up to $3,000 of ordinary income each year). In addition, any loss upon a sale or exchange of shares of our common stock by a U.S. stockholder who has held the shares for six months or less, after applying holding period rules, will be treated as a long-term capital loss to the extent of distributions received from us that were required to be treated by the U.S. stockholder as long-term capital gain.

If a U.S. stockholder recognizes a loss upon a subsequent disposition of our common stock in an amount that exceeds a prescribed threshold, it is possible that the provisions of recently adopted Treasury regulations involving "reportable transactions" could apply, with a resulting requirement to separately disclose the loss generating transaction to the IRS. While these regulations are directed towards "tax shelters," they are written quite broadly, and apply to transactions that would not typically be considered tax shelters. In addition, legislative proposals have been introduced in Congress, that, if enacted, would impose significant penalties for failure to comply with these requirements. You should consult your tax advisor concerning any possible disclosure obligation with respect to the receipt or disposition of our common stock, or transactions that might be undertaken directly or indirectly by us. Moreover, you should be aware that we and other participants in transactions involving us (including our advisors) might be subject to disclosure or other requirements pursuant to these regulations.

Passive Activity Losses and Investment Interest Limitations

Distributions made by us and gain arising from the sale or exchange by a U.S. stockholder of our common stock will not be treated as passive activity income. As a result, U.S. stockholders will not be able to apply any "passive losses" against income or gain relating to our common stock. Distributions made by us, to the extent they do not constitute a return of capital, generally will be treated as investment income for purposes of computing the investment interest limitation. A U.S. stockholder that elects to treat capital gain dividends, capital gains from the disposition of stock or qualified dividend income as investment income for purposes of the investment interest limitation will be taxed at ordinary income rates on such amounts.

Taxation of Tax-Exempt U.S. Stockholders

U.S. tax-exempt entities, including qualified employee pension and profit sharing trusts and individual retirement accounts, generally are exempt from U.S. federal income taxation. However, they are subject to taxation on their unrelated business taxable income, which we refer to in this prospectus as UBTI. While many investments in real estate generate UBTI, the IRS has ruled that dividend distributions from a REIT to a tax-exempt entity do not constitute UBTI. Based on that ruling, and provided that (1) a tax-exempt U.S. stockholder has not held our common stock as "debt financed property" within the meaning of the Internal Revenue Code (*i.e.*, where the acquisition or holding of the property is financed through a borrowing by the tax-exempt stockholder), and (2) our common stock is not otherwise used in an unrelated trade or business, distributions from us and income from the sale of our common stock generally should not be treated as UBTI to a tax-exempt U.S. stockholder.

Tax-exempt U.S. stockholders that are social clubs, voluntary employee benefit associations, supplemental unemployment benefit trusts, and qualified group legal services plans exempt from U.S. federal income taxation under sections 501(c)(7), (c)(9), (c)(17) and (c)(20) of the Internal Revenue Code, respectively, are subject to different UBTI rules, which generally will require them to characterize distributions from us as UBTI.

In certain circumstances, a pension trust (1) that is described in Section 401(a) of the Internal Revenue Code, (2) is tax exempt under section 501(a) of the Internal Revenue Code, and (3) that owns more than 10% of our stock could be required to treat a percentage of the dividends from us as UBTI if we are a "pension-held REIT." We will not be a pension-held REIT unless (1) either (A) one pension trust owns more than 25% of the value of our stock, or (B) a group of pension trusts, each individually holding more than 10% of the value of our stock, collectively owns more than 50% of such stock and (2) we would not have qualified as a REIT but for the fact that Section 856(h)(3) of the Internal Revenue Code provides that stock owned by such trusts shall be treated, for purposes of the requirement that not more than 50% of the value of the outstanding stock of a REIT is owned, directly or indirectly, by few or fewer "individuals" (as defined in the Internal Revenue Code to include certain entities). Certain restrictions on ownership and transfer of our stock should generally prevent a tax-exempt entity from owning more than 10% of the value of our stock, or us from becoming a pension-held REIT.

Tax-exempt U.S. stockholders are urged to consult their tax advisors regarding the U.S. federal, state, local and foreign tax consequences of owning our stock.

Taxation of Non-U.S. Stockholders

The following is a summary of certain U.S. federal income tax consequences of the acquisition, ownership and disposition of our common stock applicable to non-U.S. stockholders of our common stock. For purposes of this summary, a non-U.S. stockholder is a beneficial owner of our common stock that is not a U.S. stockholder. The discussion is based on current law and is for general information only. It addresses only selective and not all aspects of U.S. federal income taxation.

Ordinary Dividends. The portion of dividends received by non-U.S. stockholders payable out of our earnings and profits that are not attributable to gains from sales or exchanges of U.S. real property interests and which are not effectively connected with a U.S. trade or business of the non-U.S. stockholder will generally be subject to U.S. federal withholding tax at the rate of 30%, unless reduced or eliminated by an applicable income tax treaty. Under some treaties, however, lower rates generally applicable to dividends do not apply to dividends from REITs.

In general, non-U.S. stockholders will not be considered to be engaged in a U.S. trade or business solely as a result of their ownership of our stock. In cases where the dividend income from a non-U.S. stockholder's investment in our common stock is, or is treated as, effectively connected with the non-U.S. stockholder's conduct of a U.S. trade or business, the non-U.S. stockholder generally will be subject to U.S. federal income tax at graduated rates, in the same manner as U.S. stockholders are taxed with respect to such dividends, and may also be subject to the 30% branch profits tax on the income after the application of the income tax in the case of a non-U.S. stockholder that is a corporation.

Non-Dividend Distributions. Unless (1) our common stock constitutes a U.S. real property interest, or USRPI, or (2) either (A) if the non-U.S. stockholder's investment in our common stock is effectively connected with a U.S. trade or business conducted by such non-U.S. stockholder (in which case the non-U.S. stockholder will be subject to the same treatment as U.S. stockholders with respect to such gain) or (B) if the non-U.S. stockholder is a nonresident alien individual who was present in the United States for 183 days or more during the taxable year and has a "tax home" in the United States (in which case the non-U.S. stockholder will be subject to a 30% tax on the individual's net capital gain for the year), distributions by us which are not dividends out of our earnings and profits will not be subject to U.S. federal income tax. If it cannot be determined at the time at which a distribution is made whether or not the distribution will exceed current and accumulated earnings and profits, the distribution will be subject to withholding at the rate applicable to dividends. However, the non-U.S. stockholder may seek a refund from the IRS of any amounts withheld if it is subsequently determined that the distribution was, in fact, in excess of our current and accumulated earnings and profits. If our company's common stock constitutes a USRPI, as described below, distributions by us in excess of the sum of our earnings and profits plus the non-U.S. stockholder's adjusted tax basis in our common stock will be taxed under the Foreign Investment in Real Property Tax Act of 1980, or FIRPTA, at the rate of tax, including any applicable capital gains rates, that would apply to a U.S. stockholder of the same type (*e.g.*, an individual or a corporation, as the case may be), and the collection of the tax will be enforced by withholding at a rate of 10% of the amount by which the distribution exceeds the stockholder's share of our earnings and profits.

Capital Gain Dividends. Under FIRPTA, a distribution made by us to a non-U.S. stockholder, to the extent attributable to gains from dispositions of USRPIs held by us directly or through pass-through subsidiaries ("USRPI capital gains"), will be considered effectively connected with a U.S. trade or business of the non-U.S. stockholder and will be subject to U.S. federal income tax at the rates applicable to U.S. stockholders, without regard to whether the distribution is designated as a capital gain dividend. In addition, we will be required to withhold tax equal to 35% of the amount of capital gain dividends to the extent the dividends constitute USRPI capital gains. Distributions subject to

FIRPTA may also be subject to a 30% branch profits tax in the hands of a non-U.S. holder that is a corporation. However, the 35% withholding tax will not apply to any capital gain dividend with respect to any class of our stock that is regularly traded on an established securities market located in the United States if the non-U.S. stockholder did not own more than 5% of such class of stock at any time during the taxable year. Instead, any capital gain dividend attributable to a disposition of a USRPI will be treated as a distribution subject to the rules above under " Taxation of Non-U.S. Stockholders Ordinary Dividends." Also, the branch profits tax will not apply to such a distribution. A distribution is not a USRPI capital gain if we held the underlying asset solely as a creditor, although the holding of a shared appreciation mortgage loan would not be solely as a creditor. Capital gain dividends received by a non-U.S. stockholder from a REIT that are not USRPI capital gains are generally not subject to U.S. federal income or withholding tax, unless either (1) if the non-U.S. stockholder's investment in our common stock is effectively connected with a U.S. trade or business conducted by such non-U.S. stockholder (in which case the non-U.S. stockholder will be subject to the same treatment as U.S. stockholders with respect to such gain) or (2) if the non-U.S. stockholder is a nonresident alien individual who was present in the United States for 183 days or more during the taxable year and has a "tax home" in the United States (in which case the non-U.S. stockholder will be subject to a 30% tax on the individual's net capital gain for the year).

Dispositions of Our Common Stock. Unless our common stock constitutes a USRPI, a sale of the stock by a non-U.S. stockholder generally will not be subject to U.S. federal income taxation under FIRPTA.

The stock will not be treated as a USRPI if less than 50% of our assets throughout a prescribed testing period consist of interests in real property located within the United States, excluding, for this purpose, interests in real property solely in a capacity as a creditor. However, we expect more than 50% of our assets will consist of interests in real property located in the United States.

Regardless of the composition of our assets, our common stock will not constitute a USRPI if we are a "domestically controlled REIT." A domestically controlled REIT is a REIT in which, at all times during a specified testing period, less than 50% in value of its outstanding stock is held directly or indirectly by non-U.S. stockholders. We believe we are, and we expect to continue to be, a domestically controlled REIT and, therefore, the sale of our common stock should not be subject to taxation under FIRPTA. Because our stock will be publicly-traded, however, no assurance can be given that we are or will remain a domestically controlled REIT.

In the event that we do not constitute a domestically controlled REIT, a non-U.S. stockholder's sale of our common stock nonetheless will generally not be subject to tax under FIRPTA as a sale of a USRPI, provided that (1) our common stock is of a class that is "regularly traded," as defined by applicable Treasury Department regulations, on an established securities market, and (2) the selling non-U.S. stockholder owned, actually and constructively, 5% or less of our common stock at all times during a specified testing period.

If gain on the sale of our common stock were subject to taxation under FIRPTA, the non-U.S. stockholder would be subject to the same treatment as a U.S. stockholder with respect to such gain, subject to applicable alternative minimum tax and a special alternative minimum tax in the case of non-resident alien individuals, and the purchaser of the stock could be required to withhold 10% of the purchase price and remit such amount to the IRS.

Gain from the sale of our common stock that would not otherwise be subject to FIRPTA will nonetheless be taxable in the United States to a non-U.S. stockholder in two cases: (1) if the non-U.S. stockholder's investment in our common stock is effectively connected with a U.S. trade or business conducted by such non-U.S. stockholder, the non-U.S. stockholder will be subject to the same treatment as a U.S. stockholder with respect to such gain, or (2) if the non-U.S. stockholder is a nonresident alien individual who was present in the United States for 183 days or more during the taxable year and has a "tax home" in the United States, the nonresident alien individual will be subject to a 30% tax on the individual's capital gain.

Backup Withholding and Information Reporting

We will report to our U.S. stockholders and the IRS the amount of dividends paid during each calendar year and the amount of any tax withheld. Under the backup withholding rules, a U.S. stockholder may be subject to backup withholding with respect to dividends paid unless the holder is a corporation or comes within other exempt categories and, when required, demonstrates this fact or provides a taxpayer identification number or social security number, certifies as to no loss of exemption from backup withholding and otherwise complies with applicable requirements of the backup withholding rules. A U.S. stockholder that does not provide its correct taxpayer identification number or social security number may also be subject to penalties imposed by the IRS. In addition, we may be required to withhold a portion of capital gain distribution to any U.S. stockholder who fails to certify their non-foreign status.

We must report annually to the IRS and to each non-U.S. stockholder the amount of dividends paid to such holder and the tax withheld with respect to such dividends, regardless of whether withholding was required. Copies of the information returns reporting such dividends and withholding may also be made available to the tax authorities in the country in which the non-U.S. stockholder resides under the provisions of an applicable income tax treaty. A non-U.S. stockholder may be subject to back-up withholding unless applicable certification requirements are met.

Payment of the proceeds of a sale of our common stock within the United States is subject to both backup withholding and information reporting unless the beneficial owner certifies under penalties of perjury that it is a non-U.S. stockholder (and the payor does not have actual knowledge or reason to know that the beneficial owner is a United States person) or the holder otherwise establishes an exemption. Payment of the proceeds of a sale of our common stock conducted through certain United States related financial intermediaries is subject to information reporting (but not backup withholding) unless the financial intermediary has documentary evidence in its records that the beneficial owner is a non-U.S. stockholder and specified conditions are met or an exemption is otherwise established.

Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules may be allowed as a refund or a credit against such holder's U.S. federal income tax liability, provided the required information is furnished to the IRS.

Other Tax Considerations

Legislative or Other Actions Affecting REITs

The rules dealing with U.S. federal income taxation are constantly under review by persons involved in the legislative process and by the IRS and the U.S. Treasury Department. No assurance can be given as to whether, or in what form, the legislative proposals described below (or any other proposals affecting REITs or their stockholders) will be enacted. Changes to the federal tax laws and interpretations of federal tax laws could adversely affect an investment in our common stock.

State, Local and Foreign Taxes

Our company and our subsidiaries and stockholders may be subject to state, local or foreign taxation in various jurisdictions, including those in which it or they transact business, own property or reside. We own interests in properties located in a number of jurisdictions, and may be required to file tax returns in certain of those jurisdictions. The state, local or foreign tax treatment of our company and our stockholders may not conform to the U.S. federal income tax treatment discussed above. Any foreign taxes incurred by us would not pass through to stockholders as a credit against their U.S. federal income tax liability. Prospective stockholders should consult their tax advisors regarding the application and effect of state, local and foreign income and other tax laws on an investment in our company's common stock.

BOOK-ENTRY SECURITIES

We may issue the securities offered by means of this prospectus in whole or in part in book-entry form, meaning that beneficial owners of the securities will not receive certificates representing their ownership interests in the securities, except in the event the book-entry system for the securities is discontinued. If securities are issued in book entry form, they will be evidenced by one or more global securities that will be deposited with, or on behalf of, a depositary identified in the applicable prospectus supplement relating to the securities. The Depository Trust Company is expected to serve as depository. Unless and until it is exchanged in whole or in part for the individual securities represented thereby, a global security may not be transferred except as a whole by the depository for the global security to a nominee of such depository or by a nominee of such depository to such depository or another nominee of such depository or by the depository or any nominee of such depository to a successor depository or a nominee of such successor. Global securities may be issued in either registered or bearer form and in either temporary or permanent form. The specific terms of the depositary arrangement with respect to a class or series of securities that differ from the terms described here will be described in the applicable prospectus supplement.

Unless otherwise indicated in the applicable prospectus supplement, we anticipate that the following provisions will apply to depository arrangements.

Upon the issuance of a global security, the depository for the global security or its nominee will credit on its book-entry registration and transfer system the respective principal amounts of the individual securities represented by such global security to the accounts of persons that have accounts with such depository, who are called "participants." Such accounts shall be designated by the underwriters, dealers or agents with respect to the securities or by us if the securities are offered and sold directly by us. Ownership of beneficial interests in a global security will be limited to the depository's participants or persons that may hold interests through such participants. Ownership of beneficial interests in the global security will be shown on, and the transfer of that ownership will be effected only through, records maintained by the applicable depository or its nominee (with respect to beneficial interests of participants) and records of the participants (with respect to beneficial interests of persons who hold through participants). The laws of some states require that certain purchasers of securities take physical delivery of such securities in definitive form. Such limits and laws may impair the ability to own, pledge or transfer beneficial interest in a global security.

So long as the depository for a global security or its nominee is the registered owner of such global security, such depository or nominee, as the case may be, will be considered the sole owner or holder of the securities represented by such global security for all purposes under the applicable Indenture or other instrument defining the rights of a holder of the securities. Except as provided below or in the applicable prospectus supplement, owners of beneficial interest in a global security will not be entitled to have any of the individual securities of the series represented by such global security registered in their names, will not receive or be entitled to receive physical delivery of any such securities in definitive form and will not be considered the owners or holders thereof under the applicable Indenture or other instrument defining the rights of the holders of the securities.

Payments of amounts payable with respect to individual securities represented by a global security registered in the name of a depository or its nominee will be made to the depository or its nominee, as the case may be, as the registered owner of the global security representing such securities. None of us, our officers and board members or any trustee, paying agent or security registrar for an individual series of securities will have any responsibility or liability for any aspect of the records relating to or payments made on account of beneficial ownership interests in the global security for such securities or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.

We expect that the depository for a series of securities offered by means of this prospectus or its nominee, upon receipt of any payment of principal, premium, interest, dividend or other amount in respect of a permanent global security representing any of such securities, will immediately credit its participants' accounts with payments in amounts proportionate to their respective beneficial interests in the principal amount of such global security for such securities as shown on the records of such depository or its nominee. We also expect that payments by participants to owners of beneficial interests in such global security held through such participants will be governed by standing instructions and customary practices, as is the case with securities held for the account of customers in bearer form or registered in "street name." Such payments will be the responsibility of such participants.

If a depository for a series of securities is at any time unwilling, unable or ineligible to continue as depository and a successor depository is not appointed by us within 90 days, we will issue individual securities of such series in exchange for the global security representing such series of securities. In addition, we may, at any time and in our sole discretion, subject to any limitations described in the applicable prospectus supplement relating to such securities, determine not to have any securities of such series represented by one or more global securities and, in such event, will issue individual securities of such series in exchange for the global security or securities representing such series of securities.

PLAN OF DISTRIBUTION

We may sell the securities to one or more underwriters for public offering and sale by them or may sell the securities to investors directly or through agents. Any underwriter or agent involved in the offer and sale of the securities will be named in the applicable prospectus supplement. Underwriters and agents in any distribution contemplated hereby, including but not limited to at-the-market equity offerings, may from time to time be designated on terms to be set forth in the applicable prospectus supplement. Underwriters or agents could make sales in privately negotiated transactions and/or any other method permitted by law, including sales deemed to be an "at the market" offering as defined in Rule 415 promulgated under the Securities Act, which includes sales made directly on the New York Stock Exchange, the existing trading market for our common stock, or sales made to or through a market maker other than on an exchange. At-the-market offerings may not exceed 10% of the aggregate market value of our outstanding voting securities held by non-affiliates on a date within 60 days prior to the filing of the registration statement of which this prospectus is a part. We will not engage in an at-the-market offering prior to December 2, 2005.

Underwriters may offer and sell the securities at a fixed price or prices, which may be changed related to the prevailing market prices at the time of sale or at negotiated prices. We also may, from time to time, authorize underwriters acting as our agents to offer and sell the securities upon the terms and conditions as are set forth in the applicable prospectus supplement. In connection with the sale of securities, underwriters may be deemed to have received compensation from us in the form of underwriting discounts or commissions and may also receive commissions from purchasers of securities for whom they may act as agent. Underwriters may sell securities to or through dealers, and the dealers may receive compensation in the form of discounts, concessions or commissions from the underwriters and/or commissions from the purchasers for whom they may act as agent.

Any underwriting compensation paid by us to underwriters or agents in connection with the offering of securities, and any discounts, concessions or commissions allowed by underwriters to participating dealers, will be set forth in the applicable prospectus supplement. Underwriters, dealers and agents participating in the distribution of the securities may be deemed to be underwriters, and any discounts and commissions received by them and any profit realized by them on resale of the securities may be deemed to be underwriting discounts and commissions, under the Securities Act of 1933, as amended, or the Securities Act. Underwriters, dealers and agents may be entitled, under agreements entered into with us and our operating partnership, to indemnification against and contribution toward civil liabilities, including liabilities under the Securities Act.

Any securities issued hereunder (other than common stock) will be new issues of securities with no established trading market. Any underwriters or agents to or through whom such securities are sold by us or the operating partnership for public offering and sale may make a market in such securities, but such underwriters or agents will not be obligated to do so and may discontinue any market making at any time without notice. We cannot assure you as to the liquidity of the trading market for any such securities.

The underwriters and their affiliates may be customers of, engage in transactions with and perform services for us and the operating partnership and its subsidiaries in the ordinary course of business.

LEGAL MATTERS

Certain legal matters will be passed upon for us by Clifford Chance US LLP. Venable LLP will pass upon the validity of the shares of common stock sold and certain other matters under Maryland law. If the validity of any securities is also passed upon by counsel for the underwriters of an offering of those securities, that counsel will be named in the prospectus supplement relating to that offering.

EXPERTS

The financial statements incorporated in this Prospectus by reference to the Annual Report on Form 10-K for the year ended December 31, 2004 have been so incorporated in reliance on the report of PricewaterhouseCoopers LLP, an independent registered public accounting firm, given on the authority of said firm as experts in auditing and accounting.

The combined financial statements of Storage USA Carve-out Company as of December 31, 2004 and 2003, and for each of the years in the three-year period ended December 31, 2004, have been incorporated by reference herein in reliance upon the report of KPMG LLP, independent registered public accounting firm, incorporated by reference herein, and upon the authority of said firm as experts in accounting and auditing.

WHERE YOU CAN FIND MORE INFORMATION

We are subject to the informational requirements of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and, in accordance therewith, we file annual, quarterly and current reports, proxy statements and other information with the SEC. You may read and copy any reports, statements or other information we file at the SEC's public reference rooms located at 100 F Street, NE, Washington, D.C. 20549, and at the regional office of the SEC and at 175 W. Jackson Blvd., Suite 900, Chicago, IL 60604. Please call the SEC at 1-800-SEC-0330 for further information on the public reference rooms. Our SEC filings are also available to the public from commercial document retrieval services and at the web site maintained by the SEC at *http://www.sec.gov.* We maintain a website at *www.extra space.com*. The information on our web site is not, and you must not consider the information to be, a part of this prospectus. Our securities are listed on the NYSE and all such material filed by us with the NYSE also can be inspected at the offices of the NYSE, 20 Broad Street, New York, New York 10005.

We have filed with the SEC a registration statement on Form S-3, of which this prospectus is a part, under the Securities Act with respect to the securities. This prospectus does not contain all of the information set forth in the registration statement, certain parts of which are omitted in accordance with the rules and regulations of the SEC. For further information concerning us and the securities, reference is made to the registration statement. Statements contained in this prospectus as to the contents of any contract or other documents are not necessarily complete, and in each instance, reference is made to the copy of such contract or documents filed as an exhibit to the registration statement, each such statement being qualified in all respects by such reference.

The SEC allows us to "incorporate by reference" information into this prospectus, which means that we can disclose important information to you by referring you to another document filed separately with the SEC. The information incorporated by reference herein is deemed to be part of this prospectus, except for any information superseded by information in this prospectus. This prospectus incorporates by reference the documents set forth below that we have previously filed with the SEC. These documents contain important information about us, our business and our finances.

Document	Period
Annual Report on Form 10-K (File No. 001-32269)	Year ended December 31, 2004
Quarterly Report on Form 10-Q (File No. 001-32269)	Quarter ended March 31, 2005
Quarterly Report on Form 10-Q (File No. 001-32269)	Quarter ended June 30, 2005

Document	Dated
Current Reports on Form 8-K (File No. 001-32269)	February 16, 2005
	April 18, 2005
	May 5, 2005
	May 24, 2005
	June 20, 2005
	July 14, 2005
	July 27, 2005
	September 27, 2005

Document	Dated
Definitive Proxy Statement on Schedule 14A (File No. 001-32269)	April 21, 2005

All documents that we file pursuant to Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act after the date of this prospectus but before the end of any offering of securities made under this prospectus will also be considered to be incorporated by reference.

If you request, either orally or in writing, we will provide you with a copy of any or all documents that are incorporated by reference. Such documents will be provided to you free of charge, but will not contain any exhibits, unless those exhibits are incorporated by reference into the document. Requests should be addressed to James Overturf, Extra Space Storage Inc., 2795 East Cottonwood Parkway, Suite 400, Attn: Investor Relations, (801) 562-5556.

9,000,000 Shares

Prospectus Supplement
September , 2006

UBS Investment Bank

Banc of America Securities LLC