



Northern Natural Gas Company

**Financial Statements and Independent Auditors' Report
as of and for the
Years Ended December 31, 2012 and 2011**

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholder of
Northern Natural Gas Company
Omaha, Nebraska

We have audited the accompanying financial statements of Northern Natural Gas Company (the "Company"), which comprise the balance sheets as of December 31, 2012 and 2011, and the related statements of income, comprehensive income, changes in shareholder's equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Northern Natural Gas Company as of December 31, 2012 and 2011, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

Omaha, Nebraska
March 27, 2013

Northern Natural Gas Company
Balance Sheets
(Amounts in thousands, except share data)

	As of December 31,	
	2012	2011
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 82,762	\$ 60,916
Accounts receivable, net	65,250	63,331
Accounts receivable from affiliates	7,376	7,430
Notes receivable from MEHC	230,000	230,000
Transportation and exchange gas receivables	6,374	8,899
Inventories	23,208	24,402
Other current assets	<u>20,904</u>	<u>21,462</u>
Total current assets	435,874	416,440
Property, plant and equipment, net	2,241,931	2,205,962
Regulatory assets	158,254	152,618
Other assets	<u>42,448</u>	<u>38,538</u>
Total assets	<u>\$ 2,878,507</u>	<u>\$ 2,813,558</u>
LIABILITIES AND SHAREHOLDER'S EQUITY		
Current liabilities:		
Accounts payable	\$ 20,798	\$ 14,862
Accounts payable to affiliates	477	2,625
Accrued interest	13,626	12,783
Accrued property, income and other taxes	70,294	44,552
Transportation and exchange gas payables	5,873	7,670
Derivative contracts	8,082	10,516
Current portion of long-term debt	-	299,955
Other current liabilities	<u>28,329</u>	<u>17,845</u>
Total current liabilities	147,479	410,808
Regulatory liabilities	18,619	16,130
Derivative contracts	60,967	58,112
Asset retirement obligations	36,333	49,601
Long-term debt	899,367	649,774
Deferred income taxes	408,641	335,806
Other long-term liabilities	<u>17,390</u>	<u>18,922</u>
Total liabilities	<u>1,588,796</u>	<u>1,539,153</u>
Commitments and contingencies (Notes 6 and 11)		
Shareholder's equity:		
Series A preferred stock - 1,000 shares authorized, \$0.01 par value, no shares issued and outstanding	-	-
Common stock - 10,000 shares authorized, \$1.00 par value, 1,002 shares issued and outstanding	1	1
Additional paid-in capital	981,868	981,868
Retained earnings	307,847	294,132
Accumulated other comprehensive loss, net	<u>(5)</u>	<u>(1,596)</u>
Total shareholder's equity	<u>1,289,711</u>	<u>1,274,405</u>
Total liabilities and shareholder's equity	<u>\$ 2,878,507</u>	<u>\$ 2,813,558</u>

The accompanying notes are an integral part of these financial statements.

Northern Natural Gas Company
Statements of Income
(Amounts in thousands)

	Years Ended December 31,	
	2012	2011
Operating revenue:		
Transportation	\$ 497,909	\$ 491,974
Storage	67,056	63,013
Gas, liquids and other sales	20,134	56,833
Total operating revenue	585,099	611,820
Operating costs and expenses:		
Operating and maintenance	177,552	164,618
Cost of gas and liquids sales	23,380	54,338
Depreciation and amortization	64,123	67,022
Amortization of regulatory assets	2,216	6,899
Taxes, other than income taxes	51,685	49,883
Total operating costs and expenses	318,956	342,760
Operating income	266,143	269,060
Other income (expense):		
Interest expense, net	(51,233)	(55,209)
Interest income	1,724	1,713
Other, net	8,204	1,766
Total other income (expense)	(41,305)	(51,730)
Income before income tax expense	224,838	217,330
Income tax expense	90,123	87,176
Net income	\$ 134,715	\$ 130,154

The accompanying notes are an integral part of these financial statements.

Northern Natural Gas Company
Statements of Comprehensive Income
(Amounts in thousands)

	<u>Years Ended December 31,</u>	
	<u>2012</u>	<u>2011</u>
Net income	\$ 134,715	\$ 130,154
Other comprehensive income (loss) - Unrealized gains (losses) on cash flow hedges, net of tax of \$1,052 and \$(564)	<u>1,591</u>	<u>(853)</u>
Comprehensive income	<u>\$ 136,306</u>	<u>\$ 129,301</u>

The accompanying notes are an integral part of these financial statements.

Northern Natural Gas Company
Statements of Changes in Shareholder's Equity
(Amounts in thousands)

	<u>Common Stock</u>	<u>Additional Paid-In Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Loss, net</u>	<u>Total</u>
Balance, December 31, 2010	\$ 1	\$ 981,868	\$ 232,978	\$ (743)	\$ 1,214,104
Net income	-	-	130,154	-	130,154
Other comprehensive loss – cash flow hedges	-	-	-	(853)	(853)
Dividends on common stock	-	-	(69,000)	-	(69,000)
Balance, December 31, 2011	<u>1</u>	<u>981,868</u>	<u>294,132</u>	<u>(1,596)</u>	<u>1,274,405</u>
Net income	-	-	134,715	-	134,715
Other comprehensive income – cash flow hedges	-	-	-	1,591	1,591
Dividends on common stock	-	-	(121,000)	-	(121,000)
Balance, December 31, 2012	<u>\$ 1</u>	<u>\$ 981,868</u>	<u>\$ 307,847</u>	<u>\$ (5)</u>	<u>\$ 1,289,711</u>

The accompanying notes are an integral part of these financial statements.

Northern Natural Gas Company
Statements of Cash Flows
(Amounts in thousands)

	Years Ended December 31,	
	2012	2011
Cash flows from operating activities:		
Net income	\$ 134,715	\$ 130,154
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	64,123	67,022
Amortization of regulatory assets	2,216	6,899
Amortization of deferred financing costs	728	822
Deferred income taxes	67,280	101,072
Price risk management activities	(153)	(3,516)
Other, net	7,694	7,172
Changes in other operating assets and liabilities:		
Accounts receivable and other assets	(19,222)	(2,337)
Inventories	1,194	(482)
Accounts payable and other accrued liabilities	8,049	(2,610)
Gas balancing activities	8,290	(17,268)
Accrued property, income and other taxes	<u>28,832</u>	<u>(1,207)</u>
Net cash flows from operating activities	<u>303,746</u>	<u>285,721</u>
Cash flows from investing activities:		
Capital expenditures	(101,502)	(95,819)
Plant removal costs	(6,843)	(3,061)
Proceeds from sales of assets	<u>72</u>	<u>4,500</u>
Net cash flows from investing activities	<u>(108,273)</u>	<u>(94,380)</u>
Cash flows from financing activities:		
Repayment of long-term debt	(300,000)	(250,000)
Proceeds from long-term debt	249,565	199,956
Dividends on common stock	(121,000)	(69,000)
Issuance of promissory notes by MEHC	-	(80,000)
Debt issuance costs	<u>(2,192)</u>	<u>(2,020)</u>
Net cash flows from financing activities	<u>(173,627)</u>	<u>(201,064)</u>
Net change in cash and cash equivalents	21,846	(9,723)
Cash and cash equivalents at beginning of period	<u>60,916</u>	<u>70,639</u>
Cash and cash equivalents at end of period	<u>\$ 82,762</u>	<u>\$ 60,916</u>
Supplemental Disclosure:		
Interest paid, net of amounts capitalized	<u>\$ 49,546</u>	<u>\$ 55,026</u>
Income taxes received	<u>\$ 4,709</u>	<u>\$ 22,083</u>
Non-cash investing transactions-		
Accruals related to property, plant and equipment additions	<u>\$ 14,096</u>	<u>\$ 4,590</u>

The accompanying notes are an integral part of these financial statements.

Northern Natural Gas Company **Notes to Financial Statements**

(1) Organization and Operations

Northern Natural Gas Company (the “Company”) is an indirect wholly owned subsidiary of MidAmerican Energy Holdings Company (“MEHC”), a holding company that owns subsidiaries principally engaged in the energy business. MEHC is a consolidated subsidiary of Berkshire Hathaway Inc. (“Berkshire Hathaway”). The Company owns the largest interstate natural gas pipeline system in the United States, as measured by pipeline miles, which reaches from southern Texas to Michigan’s Upper Peninsula (the “System”). The System, which is interconnected with many interstate and intrastate pipelines in the national grid system, consists of two operationally integrated systems. Its traditional end-use and distribution market area in the northern part of its system, referred to as the Market Area, includes points in Iowa, Nebraska, Minnesota, Wisconsin, South Dakota, Michigan and Illinois. Its natural gas supply and delivery service area in the southern part of its system, referred to as the Field Area, includes points in Kansas, Texas, Oklahoma and New Mexico. The Company primarily transports and stores natural gas for utilities, municipalities, other pipeline companies, gas marketing companies, industrial and commercial users and other end-users. The System consists of 14,900 miles of natural gas pipelines, including 6,500 miles of mainline transmission pipelines and 8,400 miles of branch and lateral pipelines, with a Market Area design capacity of 5.5 billion cubic feet (“Bcf”) per day and a Field Area delivery capacity of 2.0 Bcf per day to the Market Area. Additionally, the Company has three underground natural gas storage facilities and two liquefied natural gas storage peaking units that have a total firm service and operational storage cycle capacity of over 73 Bcf and over 2.0 Bcf per day of peak delivery capability. The System is configured with approximately 2,300 active receipt and delivery points which are integrated with the facilities of local distribution companies (“LDC”). Many of the Company’s LDC customers are part of combined utilities that also use natural gas as a fuel source for electric generation. The Company delivers over 0.9 trillion cubic feet of natural gas to its customers annually.

(2) Summary of Significant Accounting Policies

Basis of Presentation and Use of Estimates in Preparation of Financial Statements

The Company has no subsidiaries. The Financial Statements are prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). The preparation of the Financial Statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period. These estimates include, but are not limited to, the effects of regulation; unbilled revenue; income taxes; valuation of certain financial assets and liabilities, including derivative contracts; long-lived asset recovery; asset retirement obligations (“AROs”); and accounting for contingencies. Actual results may differ from the estimates used in preparing the Financial Statements. The Company has evaluated subsequent events through March 27, 2013, which is the date the audited Financial Statements were available to be issued.

Accounting for the Effects of Certain Types of Regulation

The Company prepares its financial statements in accordance with authoritative guidance for regulated operations, which recognizes the economic effects of regulation. Accordingly, the Company is required to defer the recognition of certain costs or income if it is probable that, through the ratemaking process, there will be a corresponding increase or decrease in future regulated rates. Regulatory assets and liabilities are established to reflect the impacts of these deferrals.

The Company continually evaluates the applicability of the guidance for regulated operations and whether its regulatory assets and liabilities are probable of inclusion in future regulated rates by considering factors such as a change in the regulator’s approach to setting regulated rates from cost-based ratemaking to another form of regulation, other regulatory actions or the impact of competition that could limit the Company’s ability to recover its costs. The Company believes the application of the guidance for regulated operations is appropriate and its existing regulatory assets and liabilities are probable of inclusion in future regulated rates. The evaluation reflects the current political and regulatory climate at the federal level. If it becomes no longer probable that the deferred costs or income will be included in future regulated rates, the related regulatory assets and liabilities will be written-off to net income, returned to customers or re-established as accumulated other comprehensive income (loss) (“AOCI”).

Fair Value Measurements

As defined under GAAP, fair value is the price that would be received to sell an asset or paid to transfer a liability between market participants in the principal market or in the most advantageous market when no principal market exists. Adjustments to transaction prices or quoted market prices may be required in illiquid or disorderly markets in order to estimate fair value. Different valuation techniques may be appropriate under the circumstances to determine the value that would be received to sell an asset or paid to transfer a liability in an orderly transaction. Market participants are assumed to be independent, knowledgeable, able and willing to transact an exchange and not under duress. Nonperformance or credit risk is considered in determining fair value. Considerable judgment may be required in interpreting market data used to develop the estimates of fair value. Accordingly, estimates of fair value presented herein are not necessarily indicative of the amounts that could be realized in a current or future market exchange.

Cash Equivalents and Restricted Cash

Cash equivalents consist of funds invested in money market mutual funds with a maturity of three months or less when purchased. Cash and cash equivalents exclude amounts where availability is restricted by legal requirements or other contractual provisions. Restricted amounts are included in other current assets and other assets on the Balance Sheets.

Allowance for Doubtful Accounts

Accounts receivable are stated at the outstanding principal amount, net of an estimated allowance for doubtful accounts. The allowance for doubtful accounts is based on the Company's assessment of the collectibility of amounts owed to the Company by its customers. This assessment requires judgment regarding the ability of customers to pay or the outcome of any pending disputes. As of December 31, 2012 and 2011, the allowance for doubtful accounts totaled \$0.7 million and \$0.8 million, respectively, and is included in accounts receivable, net on the Balance Sheets.

Transportation Imbalances

Shippers schedule their volumes into the Company's System with subsequent deliveries to various markets. Imbalance receivables from and payables to shippers are created when receipts to the System from shippers vary from deliveries off the System, excluding quantities retained by the pipeline for fuel. Receipts and deliveries from third parties in connection with balancing and other gas service contracts also result in imbalances. Such imbalances are valued at contractual or market rates and recorded as transportation and exchange gas receivables or payables on the Balance Sheets with offsetting entries to cost of gas and liquids sales on the Statements of Income. The imbalances cause offsetting changes in the volumes of system balancing gas, which are priced at contractual or market rates, and are recorded as adjustments to system gas balances in property, plant and equipment, net on the Balance Sheets and to cost of gas and liquids sales on the Statements of Income. Settlement of imbalances occurs in accordance with the contractual terms of the agreements and timing of delivery of gas based on operational conditions.

Inventories

Inventories consist primarily of materials and supplies, which mainly include replacement parts used in the periodic overhaul of gas compressor units and materials for construction, operation and maintenance and are stated at average cost.

Derivatives

The Company employs a number of different derivative contracts, including forward gas purchase and gas sale contracts and gas price commodity and basis swaps to manage price risk for natural gas. Derivative contracts are recorded on the Balance Sheets as either assets or liabilities and are stated at estimated fair value unless they are designated as normal purchases or normal sales and qualify for the exception afforded by GAAP. Derivative balances reflect offsetting permitted under master netting agreements with counterparties.

Commodity derivatives used in normal business operations that are settled by physical delivery, among other criteria, are eligible for and may be designated as normal purchases or normal sales. Normal purchases or normal sales contracts are not marked-to-market and settled amounts are recognized as operating revenue or cost of gas and liquids sales on the Statements of Income.

For the Company's derivatives not designated as hedging contracts, the settled amount is generally includable in regulated rates. Accordingly, the net unrealized gains and losses associated with interim price movements on contracts that are accounted for as derivatives and probable of inclusion in regulated rates are recorded as regulatory assets and liabilities. For the Company's derivatives not designated as hedging contracts and for which changes in fair value are not recorded as regulatory assets and liabilities, unrealized gains and losses are recognized on the Statements of Income as operating revenue for sales contracts and cost of gas and liquids sales and operating and maintenance for purchase contracts and natural gas and fuel swap contracts.

For the Company's derivatives designated as hedging contracts, the Company formally assesses, at inception and thereafter, whether the hedging contract is highly effective in offsetting changes in the hedged item. The Company formally documents hedging activity by transaction type and risk management strategy.

Changes in the estimated fair value of a derivative contract designated and qualified as a cash flow hedge, to the extent effective, are included on the Statements of Changes in Shareholder's Equity as AOCI, net of tax, until the contract settles and the hedged item is recognized in earnings. The Company discontinues hedge accounting prospectively when it has determined that a derivative contract no longer qualifies as an effective hedge, or when it is no longer probable that the hedged forecasted transaction will occur. When hedge accounting is discontinued because the derivative contract no longer qualifies as an effective hedge, future changes in the estimated fair value of the derivative contract are charged to earnings. Gains and losses related to discontinued hedges that were previously recorded in AOCI will remain in AOCI until the contract settles and the hedged item is recognized in earnings, unless it becomes probable that the hedged forecasted transaction will not occur at which time associated deferred amounts in AOCI are immediately recognized in earnings.

Property, Plant and Equipment, Net

General

Additions to property, plant and equipment are recorded at cost. The Company capitalizes all construction-related material, direct labor and contract services, as well as indirect construction costs, which include debt and equity allowance for funds used during construction ("AFUDC") on rate base assets. The cost of additions and betterments are capitalized, while costs incurred that do not improve or extend the useful lives of the related assets are generally expensed. The Company is permitted to earn a return on the cost of its rate base assets as well as recover these costs through depreciation expense over the useful lives of the assets.

Depreciation and amortization are computed by applying the composite or straight-line method based on either estimated useful lives or mandated recovery periods as prescribed by the Federal Energy Regulatory Commission ("FERC"). Depreciation studies are completed by the Company to determine the appropriate group lives, net salvage and group depreciation rates. These studies are reviewed and rates are ultimately approved by the FERC. Under the composite method when property, plant and equipment is retired, the original cost of the property retired is charged to accumulated depreciation and amortization, net of salvage and removal costs. For general plant, the original cost of the property retired is charged to accumulated depreciation and amortization at the end of the depreciable lives of the asset vintages. Retirement gains or losses are not included in income except in the case of sales of operating units.

The Company capitalizes debt and equity AFUDC, which represents the cost of debt and equity funds necessary to finance the construction of regulated facilities, as a component of property, plant and equipment, with offsetting credits to the Statements of Income. AFUDC is computed based on guidelines set forth by the FERC.

AFUDC on borrowed funds totaled \$0.4 million for each of the years ended December 31, 2012 and 2011, and is included in interest expense, net on the Statements of Income. AFUDC on equity funds totaled \$1.2 million and \$1.0 million for the years ended December 31, 2012 and 2011, respectively, and is included in other, net on the Statements of Income.

System Gas

Storage base gas and system balancing gas are accounted for utilizing the fixed asset accounting method as prescribed by the FERC. Under this approach, system gas volumes are classified as property, plant and equipment, net and valued at cost. Temporary encroachments upon system gas are valued at contractual or current market prices.

Asset Retirement Obligations

The Company recognizes AROs when it has a legal obligation to remove or abandon-in-place an asset upon retirement. The Company's AROs are related to the decommissioning of all offshore Gulf Coast facilities. The fair value of an ARO liability is recognized in the period in which it is incurred, if a reasonable estimate of fair value can be made, and is added to the carrying amount of the associated asset, which is then depreciated over the remaining useful life of the asset. Subsequent to the initial recognition, the ARO liability is adjusted for any revisions to the original estimate of undiscounted cash flows (with corresponding adjustments to property, plant and equipment) and for accretion of the ARO liability due to the passage of time. The difference between the ARO liability, the corresponding ARO asset included in property, plant and equipment, net and amounts recovered in regulated rates to satisfy such liabilities is recorded as a regulatory asset or liability.

Impairment

The Company evaluates long-lived assets for impairment, including property, plant and equipment, when events or changes in circumstances indicate that the carrying value of such assets may not be recoverable, or the assets are being held for sale. Upon the occurrence of a triggering event, the asset is reviewed to assess whether the estimated undiscounted cash flows expected from the use of the asset plus the residual value from the ultimate disposal exceeds the carrying value of the asset. If the carrying value exceeds the estimated recoverable amounts, the asset is written down to the estimated fair value. The impacts of regulation are considered when evaluating the carrying value of rate base assets. For non-rate base assets, any resulting impairment loss is reflected on the Statements of Income.

Revenue Recognition

Revenue from customers is recognized as natural gas is delivered or services are provided. Revenue recognized includes billed and unbilled amounts. As of December 31, 2012 and 2011, unbilled revenue was \$9.8 million and \$5.0 million, respectively, and is included in accounts receivable, net on the Balance Sheets. The Company's transportation and storage revenue is primarily derived from fixed reservation charges based on contractual quantities and regulated rates. The remaining revenue, consisting primarily of commodity charges, is based on contractual rates and estimated usage based on scheduled quantities. Differences between scheduled quantities and actual measured quantities are reflected in revenue during the following month and historically have been immaterial.

The Company is subject to FERC regulations and, accordingly, certain revenue collected may be subject to possible refunds upon final FERC orders in pending regulated rate proceedings. The Company may record revenue that is subject to refund based on its best estimates of the final outcomes of such proceedings and other third party regulatory proceedings, advice of counsel and estimated total exposure, as well as collection and other risks. The Company had no earned revenue subject to refund for the years ended December 31, 2012 and 2011.

Income Taxes

Berkshire Hathaway includes MEHC and its subsidiaries in its United States federal income tax return. Consistent with established regulatory practice, the Company's provision for income tax expense has been computed on a stand-alone basis, and substantially all of its respective currently payable or receivable income taxes are remitted to or received from MEHC.

Deferred income tax assets and liabilities are based on differences between the financial statement and income tax basis of assets and liabilities using estimated income tax rates expected to be in effect for the year in which the differences are expected to reverse. Changes in deferred income tax assets and liabilities that are associated with components of other comprehensive income ("OCI") are charged or credited directly to OCI. Other changes in deferred income tax assets and liabilities are included as a component of income tax expense. Valuation allowances are established for certain deferred income tax assets where realization is not likely.

In determining the Company's income taxes, management is required to interpret complex income tax laws and regulations, which includes consideration of regulatory implications imposed by the FERC. The Company's income tax returns are subject to continuous examinations by federal, state and local income tax authorities that may give rise to different interpretations of these complex laws and regulations. Due to the nature of the examination process, it generally takes years before these examinations are completed and these matters are resolved. The Company recognizes the tax benefit from an uncertain tax position only if it is more-likely-than-not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the Financial Statements from such a position are measured based on the largest benefit that is more-likely-than-not of being realized upon ultimate settlement.

Although the ultimate resolution of the Company's federal, state and local income tax examinations is uncertain, the Company believes it has made adequate provisions for these income tax positions. The aggregate amount of any additional income tax liabilities that may result from these examinations, if any, is not expected to have a material adverse impact on the Company's financial results. The Company's unrecognized tax benefits are included in other current assets and other long-term liabilities on the Balance Sheets. Estimated interest and penalties, if any, related to uncertain tax positions are included as a component of income tax expense on the Statements of Income.

New Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2013-02, which amends FASB Accounting Standards Codification ("ASC") Topic 220, "Comprehensive Income." The amendments in this guidance require an entity to provide information about the amounts reclassified out of AOCI by component. In addition, an entity is required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of AOCI by the respective line items of net income if the amount reclassified is required under GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required by GAAP that provide additional detail about those amounts. This guidance is effective prospectively for annual reporting periods beginning after December 15, 2013. The Company is currently evaluating the impact of adopting this guidance on its Financial Statements and disclosures included within Notes to Financial Statements.

In December 2011, the FASB issued ASU No. 2011-11, which amends FASB ASC Topic 210, "Balance Sheet." The amendments in this guidance require an entity to provide quantitative disclosures about offsetting financial instruments and derivative instruments. Additionally, this guidance requires qualitative and quantitative disclosures about master netting agreements or similar agreements when the financial instruments and derivative instruments are not offset. This guidance is effective for fiscal years beginning on or after January 1, 2013, and for interim periods within those fiscal years. In January 2013, the FASB issued ASU No. 2013-01, which also amends FASB ASC Topic 210 to clarify that the scope of ASU No. 2011-11 only applies to derivative instruments, repurchase agreements, reverse purchase agreements and securities borrowing and securities lending transactions that are either being offset or are subject to an enforceable master netting arrangement or similar agreement. ASU No. 2013-01 is also effective for fiscal years beginning on or after January 1, 2013, and for interim periods within those fiscal years. The Company is currently evaluating the impact of adopting this guidance on its disclosures included within Notes to Financial Statements.

In June 2011, the FASB issued ASU No. 2011-05, which amends FASB ASC Topic 220, "Comprehensive Income." ASU No. 2011-05 provides an entity with the option to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Regardless of the option chosen, this guidance also requires presentation of items on the face of the financial statements that are reclassified from other comprehensive income to net income. This guidance does not change the items that must be reported in other comprehensive income, when an item of other comprehensive income must be reclassified to net income or how tax effects of each item of other comprehensive income are presented. This guidance is effective for interim and annual reporting periods beginning after December 15, 2011. In December 2011, the FASB issued ASU No. 2011-12, which also amends FASB ASC Topic 220 to defer indefinitely the ASU No. 2011-05 requirement to present items on the face of the financial statements that are reclassified from other comprehensive income to net income. ASU No. 2011-12 is also effective for interim and annual reporting periods beginning after December 15, 2011. The Company adopted this guidance on January 1, 2012 and elected the two separate but consecutive statements option.

In May 2011, the FASB issued ASU No. 2011-04, which amends FASB ASC Topic 820, "Fair Value Measurements and Disclosures." The amendments in this guidance are not intended to result in a change in current accounting. ASU No. 2011-04 requires additional disclosures relating to fair value measurements categorized within Level 3 of the fair value hierarchy, including quantitative information about unobservable inputs, the valuation process used by the entity and the sensitivity of unobservable input measurements. Additionally, entities are required to disclose the level of the fair value hierarchy for assets and liabilities that are not measured at fair value in the balance sheet, but for which disclosure of the fair value is required. This guidance is effective for interim and annual reporting periods beginning after December 15, 2011. The Company adopted ASU No. 2011-04 on January 1, 2012. The adoption of this guidance did not have a material impact on the Company's disclosures included within Notes to Financial Statements.

(3) Property, Plant and Equipment, Net

Property, plant and equipment, net consists of the following as of December 31 (in thousands):

	Depreciation Rates	2012	2011
Transmission and other plant	1.5% to 10.0%	\$ 2,696,892	\$ 2,656,259
Storage plant ⁽¹⁾	1.25% to 2.34%	537,944	516,200
Intangible plant ⁽²⁾	4.4% to 20.0%	118,990	121,623
General plant and buildings	2.75% to 10.0%	<u>110,653</u>	<u>112,821</u>
Total operating assets		3,464,479	3,406,903
Accumulated depreciation and amortization		<u>(1,239,943)</u>	<u>(1,210,475)</u>
Net operating assets		2,224,536	2,196,428
Construction in progress		<u>17,395</u>	<u>9,534</u>
Property, plant and equipment, net		<u>\$ 2,241,931</u>	<u>\$ 2,205,962</u>

(1) Includes system-gas and market-based underground storage facilities. Recoverable system gas is not depreciated.

(2) Includes costs for capitalized software development, contributions in aid of construction, organization and leasehold improvements.

The Company had gross costs for capitalized software development of \$99.9 million and \$99.7 million and accumulated amortization of \$38.8 million and \$38.3 million as of December 31, 2012 and 2011, respectively, which is included in intangible plant and reflected in property, plant and equipment, net on the Balance Sheets. Capitalized software development costs are amortized at a rate of 4.4%.

The Company had gross costs for capitalized right of use or right of way of \$100.3 million and \$102.5 million and accumulated amortization of \$28.2 million and \$26.8 million as of December 31, 2012 and 2011, respectively, which is included in transmission and other plant and storage plant and reflected in property, plant and equipment, net on the Balance Sheets. Capitalized right of use or right of way costs are amortized at rates ranging from 1.25% to 10.00%.

For the years ended December 31, 2012 and 2011, depreciation expense of \$57.0 million and \$56.4 million, respectively, and amortization expense of \$7.1 million and \$10.6 million, respectively, were included in depreciation and amortization on the Statements of Income. The Company expects amortization expense to be \$7.0 million for 2013, \$7.0 million for 2014, \$7.0 million for 2015, \$7.0 million for 2016 and \$6.8 million for 2017.

(4) Regulatory Matters

Regulatory assets represent costs that are expected to be recovered in future regulated rates. The Company's regulatory assets reflected on the Balance Sheets consist of the following as of December 31 (in thousands):

	Weighted Average Remaining Life	2012	2011
Unrealized loss on regulated derivative contracts	10 years	\$ 68,825	\$ 63,907
AROs	8 years	34,708	31,987
Smart pigging and hydrostatic testing costs	7 years	29,823	25,047
Deferred income taxes associated with equity AFUDC ⁽¹⁾	67 years	15,502	14,980
Migration and system upgrade costs	2 years	2,181	3,370
Employee benefit plan ⁽²⁾	12 years	3,462	5,119
Fuel trackers periodic rate adjustments	1 year	5,211	6,619
Other	Various	4,838	9,346
Total regulatory assets		<u>\$ 164,550</u>	<u>\$ 160,375</u>
Reflected as:			
Current assets ⁽³⁾		\$ 6,296	\$ 7,757
Noncurrent assets		<u>158,254</u>	<u>152,618</u>
Total regulatory assets		<u>\$ 164,550</u>	<u>\$ 160,375</u>

(1) Amortized at the same rate as onshore transmission plant.

(2) Represents amounts not yet recognized as a component of net periodic benefit cost that are expected to be included in regulated rates when recognized.

(3) Current regulatory assets are included in other current assets on the Balance Sheets.

The Company had regulatory assets not earning a return on investment of \$110.7 million and \$110.5 million as of December 31, 2012 and 2011, respectively.

Regulatory liabilities represent income to be recognized or amounts to be returned to customers in future periods. The Company's regulatory liabilities reflected on the Balance Sheets consist of the following as of December 31 (in thousands):

	Weighted Average Remaining Life	2012	2011
Employee benefit plan ⁽¹⁾	12 years	\$ 18,128	\$ 15,445
Other	Various	1,901	2,151
Total regulatory liabilities		<u>\$ 20,029</u>	<u>\$ 17,596</u>
Reflected as:			
Current liabilities ⁽²⁾		\$ 1,410	\$ 1,466
Noncurrent liabilities		<u>18,619</u>	<u>16,130</u>
Total regulatory liabilities		<u>\$ 20,029</u>	<u>\$ 17,596</u>

(1) Represents amounts not yet recognized as a component of net periodic benefit cost that are to be returned to customers in future periods when recognized.

(2) Current regulatory liabilities are included in other current liabilities on the Balance Sheets.

(5) Fair Value Measurements

The carrying value of the Company's cash, certain cash equivalents, receivables, payables and accrued liabilities approximates fair value because of the short-term maturity of these instruments. The Company has various financial assets and liabilities that are measured at fair value on the Financial Statements using inputs from the three levels of the fair value hierarchy. A financial asset or liability classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement. The three levels are as follows:

- Level 1 – Inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.
- Level 2 – Inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability and inputs that are derived principally from or corroborated by observable market data by correlation or other means (market corroborated inputs).
- Level 3 – Unobservable inputs reflect the Company's judgments about the assumptions market participants would use in pricing the asset or liability since limited market data exists. The Company develops these inputs based on the best information available, including its own data.

The following table presents the Company's assets and liabilities recognized on the Balance Sheets and measured at fair value on a recurring basis (in thousands):

	Input Levels for Fair Value Measurements			Other⁽¹⁾	Total
	Level 1	Level 2	Level 3		
<u>As of December 31, 2012</u>					
Assets:					
Commodity derivatives	\$ -	\$ 870	\$ -	\$ (654)	\$ 216
Money market mutual funds ⁽²⁾	<u>103,323</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>103,323</u>
	<u>\$ 103,323</u>	<u>\$ 870</u>	<u>\$ -</u>	<u>\$ (654)</u>	<u>\$ 103,539</u>
Liabilities - commodity derivatives	<u>\$ -</u>	<u>\$ (69,703)</u>	<u>\$ -</u>	<u>\$ 654</u>	<u>\$ (69,049)</u>
<u>As of December 31, 2011</u>					
Commodity derivatives	\$ -	\$ 4,331	\$ -	\$ (2,415)	\$ 1,916
Money market mutual funds ⁽²⁾	<u>65,013</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>65,013</u>
	<u>\$ 65,013</u>	<u>\$ 4,331</u>	<u>\$ -</u>	<u>\$ (2,415)</u>	<u>\$ 66,929</u>
Liabilities - commodity derivatives	<u>\$ -</u>	<u>\$ (71,043)</u>	<u>\$ -</u>	<u>\$ 2,415</u>	<u>\$ (68,628)</u>

(1) Represents netting under master netting arrangements.

(2) Amounts are included in cash and cash equivalents, other current assets and other assets on the Balance Sheets. The fair value of these money market mutual funds approximates cost.

Derivative contracts are recorded on the Balance Sheets as either assets or liabilities and are stated at fair value unless they are designated as normal purchases or normal sales and qualify for the exception afforded by GAAP. When available, the fair value of derivative contracts is estimated using unadjusted quoted prices for identical contracts in the market in which the Company transacts. When quoted prices for identical contracts are not available, the Company uses forward price curves. Forward price curves represent the Company's estimates of the prices at which a buyer or seller could contract today for delivery or settlement at future dates. The Company bases its forward price curves upon market price quotations, when available, or internally developed and commercial models, with internal and external fundamental data inputs. Market price quotations are obtained from independent energy brokers, exchanges, direct communication with market participants and actual transactions executed by the Company. Market price quotations for certain major natural gas trading hubs are generally readily obtainable for the applicable term of the Company's outstanding derivative contracts; therefore, the Company's forward price curves for those locations and periods reflect observable market quotes. The estimated fair value of these derivative contracts is a function of underlying forward commodity prices, related volatility, counterparty creditworthiness

and duration of contracts. Refer to Note 6 for further discussion regarding the Company's risk management and hedging activities.

The Company's investments in money market mutual funds are accounted for as available-for-sale securities and are stated at fair value. A readily observable quoted market price or net asset value of an identical security in an active market is used to record the fair value.

The Company's long-term debt is carried at cost on the Financial Statements. The fair value of the Company's long-term debt is a Level 2 fair value measurement and has been estimated based upon quoted market prices, where available, or at the present value of future cash flows discounted at rates consistent with comparable maturities with similar credit risks. The following table presents the carrying value and estimated fair value of the Company's long-term debt as of December 31 (in thousands):

	2012		2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Long-term debt	\$ 899,367	\$ 1,022,999	\$ 949,729	\$ 1,078,876

(6) Risk Management and Hedging Activities

The Company is exposed to the impact of market fluctuations in natural gas prices as supply and demand are impacted by, among many other unpredictable items, weather, market liquidity, customer usage, storage and transportation constraints. The Company does not engage in a material amount of proprietary trading activities.

The Company has established a risk management process that is designed to identify, assess, monitor, report, manage and mitigate each of the various types of risk involved in its business. To mitigate a portion of its natural gas price risk, the Company uses commodity derivative contracts generally at fixed prices to hedge natural gas for operational and preferred deferred delivery ("PDD") storage, storage losses, fuel requirements and other transactions. The Company uses natural gas commodity swaps to hedge the margin on forecasted gas sales and purchases required for operational storage balancing purposes, to hedge the margin on anticipated future PDD storage contracts and to hedge the cost of replacing forecasted storage losses.

For certain designated markets, certain customers pay a fixed price of \$.09 per decatherm ("dth") of volumes delivered to purchase compressor fuel and system use gas from the Company. The Company estimates it will be required to purchase an annual average of 1.0 Bcf of natural gas through October 2022 to meet these requirements based on a projected average system requirements factor of 1.2% of volumes delivered. The Company's contracts with these customers provide service through October 2019, with annual renewal options for one customer to continue service through October 2022. As of December 31, 2012, the Company had purchased gas and entered into swap agreements covering more than the expected contractual requirements through October 2022.

Interest rate risk exists on future debt issuances. The Company manages its interest rate risk by limiting its exposure to variable interest rates primarily through the issuance of fixed-rate long-term debt and by monitoring market changes in interest rates. Additionally, the Company may from time to time enter into interest rate derivative contracts, such as interest rate swaps or locks, to mitigate the Company's exposure to interest rate risk. The Company does not hedge all of its commodity price and interest rate risks, thereby exposing the unhedged portion to changes in market prices.

There have been no significant changes in the Company's accounting policies related to derivatives. Refer to Notes 2 and 5 for additional information on derivative contracts.

The following table, which reflects master netting arrangements and excludes contracts that have been designated as normal under the normal purchases or normal sales exception afforded by GAAP, summarizes the fair value of the Company's derivative contracts, on a gross basis, and reconciles those amounts to the amounts presented on a net basis on the Balance Sheets (in thousands):

	Derivative Assets		Derivative Liabilities		Total
	Current ⁽¹⁾	Noncurrent	Current	Noncurrent	
As of December 31, 2012					
Not designated as hedging contracts⁽²⁾:					
Commodity assets	\$ 226	\$ -	\$ 148	\$ -	\$ 374
Commodity liabilities	(2)	-	(8,230)	(60,967)	(69,199)
Total	<u>224</u>	<u>-</u>	<u>(8,082)</u>	<u>(60,967)</u>	<u>(68,825)</u>
Designated as cash flow hedging contracts:					
Commodity assets	496	-	-	-	496
Commodity liabilities	(504)	-	-	-	(504)
Total	<u>(8)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(8)</u>
Total derivatives - net basis⁽³⁾	<u>\$ 216</u>	<u>\$ -</u>	<u>\$ (8,082)</u>	<u>\$ (60,967)</u>	<u>\$ (68,833)</u>
As of December 31, 2011					
Not designated as hedging contracts⁽²⁾:					
Commodity assets	\$ 2,773	\$ -	\$ 1,240	\$ -	\$ 4,013
Commodity liabilities	(863)	-	(8,970)	(58,087)	(67,920)
Total	<u>1,910</u>	<u>-</u>	<u>(7,730)</u>	<u>(58,087)</u>	<u>(63,907)</u>
Designated as cash flow hedging contracts:					
Commodity assets	6	-	-	312	318
Commodity liabilities	-	-	(2,786)	(337)	(3,123)
Total	<u>6</u>	<u>-</u>	<u>(2,786)</u>	<u>(25)</u>	<u>(2,805)</u>
Total derivatives - net basis⁽³⁾	<u>\$ 1,916</u>	<u>\$ -</u>	<u>\$ (10,516)</u>	<u>\$ (58,112)</u>	<u>\$ (66,712)</u>

(1) Current derivative assets are included in other current assets on the Balance Sheets.

(2) The Company's commodity derivatives not designated as hedging contracts are generally included in regulated rates, and as of December 31, 2012 and 2011, a regulatory asset of \$68.8 million and \$63.9 million, respectively, was recorded related to the net derivative liability of \$68.8 million and \$63.9 million, respectively.

(3) The net notional amounts of outstanding commodity derivative contracts with fixed price terms that comprise the mark-to-market values included above is 19 million dth and 21 million dth of natural gas purchases as of December 31, 2012 and 2011, respectively.

Not Designated as Hedging Contracts

The following table reconciles the beginning and ending balances of the Company's regulatory assets and summarizes the pre-tax gains and losses on commodity derivative contracts recognized in regulatory assets, as well as amounts reclassified to earnings for the years ended December 31 (in thousands):

	2012	2011
Beginning balance	\$ 63,907	\$ 50,124
Changes in fair value recognized in regulatory assets	9,936	22,407
Net gains (losses) reclassified to operating revenue	4,504	(6,227)
Net losses reclassified to cost of gas and liquids sales	(9,522)	(2,397)
Ending balance	<u>\$ 68,825</u>	<u>\$ 63,907</u>

Designated as Hedging Contracts

The following table reconciles the beginning and ending balances of the Company's accumulated other comprehensive loss (pre-tax) and summarizes pre-tax gains and losses on commodity derivative contracts designated and qualifying as cash flow hedges recognized in OCI, as well as amounts reclassified to earnings for the years ended December 31 (in thousands):

	<u>2012</u>	<u>2011</u>
Beginning balance⁽¹⁾	\$ 2,651	\$ 2,475
Changes in fair value recognized in OCI	(707)	(1,898)
Net (losses) gains reclassified to operating revenue	(1,936)	3,575
Net losses reclassified to cost of gas and liquids sales	-	(1,501)
Ending balance⁽¹⁾	<u>\$ 8</u>	<u>\$ 2,651</u>

- (1) Certain derivative contracts have settled and the fair value at the date of settlement remains in accumulated other comprehensive loss and is recognized in earnings when the forecasted transactions impact earnings.

Realized gains and losses on hedges and hedge ineffectiveness are recognized on the Statements of Income as operating revenue or cost of gas and liquids sales depending upon the nature of the item being hedged. For the years ended December 31, 2012 and 2011, hedge ineffectiveness was insignificant. As of December 31, 2012, the Company had cash flow hedges with expiration dates extending through December 2013 and the pre-tax unrealized losses forecasted to be reclassified from accumulated other comprehensive loss into earnings over the next twelve months are insignificant.

Credit Risk

The Company extends unsecured credit to energy marketing companies, financial institutions and other market participants in conjunction with its derivative contracts. Credit risk relates to the risk of loss that might occur as a result of nonperformance by counterparties on their contractual obligations to make or take delivery of natural gas and to make financial settlements of these obligations. Credit risk may be concentrated to the extent that one or more groups of counterparties have similar economic, industry or other characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in market or other conditions. In addition, credit risk includes not only the risk that a counterparty may default due to circumstances relating directly to it, but also the risk that a counterparty may default due to circumstances involving other market participants that have a direct or indirect relationship with the counterparty.

The Company analyzes the financial condition of each counterparty before entering into any transactions, establishes limits on the amount of unsecured credit to be extended to each counterparty and evaluates the appropriateness of unsecured credit limits on an ongoing basis. To mitigate exposure to the financial risks of counterparties, the Company enters into netting arrangements that may include margining and may obtain third-party guarantees, letters of credit and cash deposits. Counterparties may be assessed fees for delayed payments. If required, the Company exercises rights under these arrangements, including calling on the counterparty's credit support arrangement.

Collateral and Contingent Features

In accordance with industry practice, certain derivative contracts contain provisions that require the Company to maintain specific credit ratings from one or more of the major credit rating agencies on its unsecured debt. These derivative contracts may either specifically provide bilateral rights to demand cash or other security if credit exposures on a net basis exceed specified rating-dependent threshold levels ("credit-risk-related contingent features"). These rights can vary by contract and by counterparty. As of December 31, 2012, the Company's credit ratings from the three recognized credit rating agencies were investment grade.

The aggregate fair value of the Company's derivative contracts in liability positions with specific credit-risk-related contingent features totaled \$69.7 million and \$71.0 million as of December 31, 2012 and 2011, respectively, for which the Company had not posted collateral. If all credit-risk-related contingent features for derivative contracts in liability positions had been triggered as of December 31, 2012 and 2011, the Company would have been required to post \$69.0 million and \$68.6 million, respectively, of collateral. The Company's collateral requirements could fluctuate considerably due to market price volatility, changes in credit ratings, changes in legislation or regulation, or other factors.

(7) Asset Retirement Obligations

The Company estimates its ARO liabilities based upon detailed engineering calculations of the amount and timing of the future cash spending for a third party to perform the required work. Spending estimates are escalated for inflation and then discounted at a credit-adjusted, risk-free rate. Changes in estimates could occur for a number of reasons, including plan revisions, inflation and changes in the amount and timing of the expected work.

The Company has concluded that it is legally obligated to remove, or abandon-in-place, its onshore pipeline and related equipment upon the final retirement of the pipeline. While interim removal or abandonment-in-place and replacement of such equipment is probable, the final retirement dates of these assets are not determinable, and therefore, the liabilities for their removal cannot be reasonably estimated. The Company has also identified AROs related to asbestos siding on some of its buildings. Because both the methods of settlement and the timing of the retirements are unknown, the amounts of these obligations cannot be reasonably estimated to determine the fair value of these obligations.

The following table reconciles the beginning and ending balances of the Company's ARO liabilities for the years ended December 31 (in thousands):

	<u>2012</u>	<u>2011</u>
Beginning balance	\$ 49,601	\$ 60,966
Change in estimated costs	(7,081)	(14,270)
Retirements	(7,957)	-
Accretion	<u>1,770</u>	<u>2,905</u>
Ending balance	<u>\$ 36,333</u>	<u>\$ 49,601</u>

The Company's ARO liability relates to the abandonment of pipeline assets located in offshore waters. In response to the Company's request to abandon in-place certain pipelines located in offshore Texas waters, the United States Corps of Engineers, Galveston District, determined that one of the pipelines, which is located in San Antonio Bay, must be removed. That pipeline has been removed and the remaining pipelines, as identified in the Company's request, were abandoned in-place. This resulted in a reduction of estimated costs in 2011. Lower contract rates for ships and crew based on third party bids resulted in a reduction of estimated costs in 2012. These changes in the ARO liabilities did not impact earnings in 2012 or 2011.

(8) Long-Term Debt

Long-term debt consists of the following, including unamortized premiums and discounts, as of December 31 (dollars in thousands):

	<u>Par Value</u>	<u>2012</u>	<u>2011</u>
Long-term debt:			
5.375% Senior Notes, due 2012	\$ -	\$ -	\$ 299,955
5.125% Senior Notes, due 2015	100,000	99,962	99,948
5.75% Senior Notes, due 2018	200,000	199,971	199,967
4.25% Senior Notes, due 2021	200,000	199,962	199,958
5.8% Senior Bonds, due 2037	150,000	149,903	149,901
4.1% Senior Bonds, due 2042	<u>250,000</u>	<u>249,569</u>	-
Total long-term debt	<u>\$ 900,000</u>	<u>\$ 899,367</u>	<u>\$ 949,729</u>

All of the Company's senior notes and bonds are due and payable on their respective maturity dates and none have mandatory prepayment terms.

The Company is prohibited from making distributions in respect of the shares of its capital stock unless, on the date of any such distribution, none of certain specified events of default exist under its senior unsecured debt and either (1) at the time and as a result of such distribution, the ratio of its debt to its total capital does not exceed 0.65 to 1.0 and the ratio of its earnings before interest, taxes, depreciation and amortization, to its interest expense is not less than 2.5 to 1.0, or (2) if the Company is not in compliance with such ratios, its senior unsecured long-term debt rating is at least BBB (or its then equivalent) from Standard and Poor's and Baa2 (or its then equivalent) from Moody's Investors Service, Inc.

In August 2012, the Company issued \$250.0 million of its 4.1% Senior Bonds due September 2042. The net proceeds were used to partially repay the Company's \$300.0 million, 5.375% Senior Notes due October 2012.

(9) Income Taxes

Income tax expense (benefit) consists of the following for the years ended December 31 (in thousands):

	<u>2012</u>	<u>2011</u>
Current:		
Federal	\$ 17,313	\$ (14,359)
State	<u>5,530</u>	<u>463</u>
	<u>22,843</u>	<u>(13,896)</u>
Deferred:		
Federal	55,311	84,689
State	<u>11,969</u>	<u>16,383</u>
	<u>67,280</u>	<u>101,072</u>
Total	<u>\$ 90,123</u>	<u>\$ 87,176</u>

A reconciliation of the federal statutory income tax rate to the effective income tax rate applicable to income before income tax expense is as follows for the years ended December 31:

	<u>2012</u>	<u>2011</u>
Federal statutory income tax rate	35.0%	35.0%
State income tax, net of federal income tax benefit	<u>5.1</u>	<u>5.1</u>
Effective income tax rate	<u>40.1%</u>	<u>40.1%</u>

The net deferred income tax liability consists of the following as of December 31 (in thousands):

	<u>2012</u>	<u>2011</u>
Deferred income tax assets:		
Acquired goodwill	\$ 111,145	\$ 138,364
Regulatory liabilities	11,004	11,224
Net unrealized losses on derivative contracts	27,397	27,329
AROs	14,461	19,742
State carryforwards	11,867	11,985
Other	<u>22,326</u>	<u>19,324</u>
Total deferred income tax assets	198,200	227,968
Valuation allowance	<u>(8,641)</u>	<u>(9,151)</u>
Total deferred income tax assets, net	<u>189,559</u>	<u>218,817</u>
Deferred income tax liabilities:		
Property, plant and equipment, net	(547,811)	(513,327)
Regulatory assets	(37,320)	(27,784)
Employee benefits	(6,696)	(8,185)
Other	<u>(1,314)</u>	<u>(4,771)</u>
Total deferred income tax liabilities	<u>(593,141)</u>	<u>(554,067)</u>
Net deferred income tax liability	<u>\$ (403,582)</u>	<u>\$ (335,250)</u>
Reflected as:		
Other current assets	\$ 5,059	\$ 556
Deferred income taxes - non-current liability	<u>(408,641)</u>	<u>(335,806)</u>
	<u>\$ (403,582)</u>	<u>\$ (335,250)</u>

Acquired goodwill resulted from the income tax treatment by the Company's predecessor owners of their January 2002 acquisition of the Company. Acquired goodwill is being amortized for tax purposes through January 2017.

As of December 31, 2012, the Company has available \$11.9 million of state carryforwards, consisting of net operating losses and credits that expire at various intervals between 2013 and 2016. The valuation allowance primarily relates to Nebraska state credit carryforwards that are not expected to be realized.

The United States Internal Revenue Service has closed examination of MEHC's income tax returns through February 2006, including components related to the Company. In addition, state jurisdictions have closed examination of MEHC's income tax returns through at least February 9, 2006.

(10) Employee Benefit Plans

The Company is a participant in benefit plans sponsored by MidAmerican Energy Company ("MEC"), an indirect wholly owned subsidiary of MEHC. The MidAmerican Energy Company Retirement Plan provides pension benefits for eligible employees ("pension plan") and the MidAmerican Energy Company Welfare Benefit Plan provides certain postretirement health care and life insurance benefits for eligible retirees ("other postretirement plan") on behalf of the Company. The Company's contributions to the pension and other postretirement plans were \$1.3 million and \$1.1 million for the years ended December 31, 2012 and 2011, respectively. As of December 31, 2012, the Company recorded an affiliate company payable included in other long-term liabilities relating to the pension plan and an affiliate company receivable included in other assets relating to the other postretirement plan of \$3.5 million and \$18.1 million, respectively. As of December 31, 2011, the Company recorded an affiliate company payable included in other long-term liabilities relating to the pension plan and an affiliate company receivable included in other assets relating to the other postretirement plan of \$5.1 million and \$15.4 million, respectively. Amounts attributable to the Company were allocated from MEC to the Company in accordance with the intercompany administrative service agreement. Offsetting regulatory assets and liabilities have been recorded related to the amounts not yet recognized as a component of net periodic benefit costs that will be included in regulated rates.

(11) Commitments and Contingencies

In September 2012, an unplanned interruption of the Company's service occurred at a customer's location. The Company has received a draft report from the customer's third-party consultant alleging a potential loss of approximately \$20.0 million. The Company has accrued an estimated liability as of December 31, 2012 and believes the ultimate outcome will not be material to the Company's financial results.

Legal Matters

The Company is party to a variety of legal actions arising out of the normal course of business. Plaintiffs occasionally seek punitive or exemplary damages. The Company does not believe that such normal and routine litigation will have a material impact on its financial results. The Company is also involved in other kinds of legal actions, some of which assert or may assert claims or seek to impose fines, penalties and other costs in substantial amounts and are described below.

The Company's storage gas has migrated from its former certificated storage field boundaries near Cunningham, Kansas and has been produced on leaseholds held by Nash Oil & Gas, Inc. ("Nash"), L.D. Drilling Company ("LD Drilling"), Val Energy, Inc. ("Val Energy") and Iuka-Carmi Development, LLC. In order to mitigate its losses, the Company has initiated the following actions:

- In September 2009, the Company filed an application with the FERC to extend the boundaries of the Cunningham natural gas storage facility. In June 2010, FERC issued an order granting the Company certificate authority to extend the boundaries of the Cunningham natural gas storage facility by 12,320 acres. The Company has either acquired leases or purchased the property on 3,580 acres, or 29% of the extension area. In July 2010, the Company filed a complaint in federal district court to acquire the remaining necessary interests by eminent domain. In June 2011, the Company filed a motion for preliminary injunction seeking access to the extension area to construct the facilities necessary to implement its containment plan to control the migrating storage gas. In March 2012, the federal district court judge issued an order granting the Company's motion for the preliminary injunction and required security in the form of a cash deposit of \$2.7 million and a bond of \$7.8 million, both of which were deposited with the court by the Company. The court established a three-person compensation commission in September 2012, to determine the value of the interests to be taken. The Company and the defendants are in discovery and deposing witnesses. The next status conference is in May 2013.
- The Company filed a lawsuit in December 2008 against Nash, LD Drilling and Val Energy in the United States District Court for the District of Kansas ("District Court") for conversion, nuisance and unjust enrichment. Shortly

after the FERC order granting the Company authority to expand the boundaries of the Cunningham natural gas storage facility was issued in June 2010, the Company filed a motion to shut-in the production of the third-party wells producing the Company's storage gas. In December 2010, the District Court granted the Company's motion and ordered all of the wells in the extension area to be shut-in, which was completed in February 2011. The defendants appealed the injunction order to the Tenth Circuit Court of Appeals. Oral argument on the appeal was held in November 2011. The Tenth Circuit Court of Appeals affirmed the District Court decision in October 2012. Discovery had been stayed pending the outcome of the Kansas Supreme Court appeal discussed below. The case will now move forward on the Company's nuisance claim and the Company's conversion claim for gas produced after the June 2010 FERC order.

- In December 2009, the Company filed a lawsuit in the 13th Judicial District, District Court, Pratt County, Kansas ("Pratt County State District Court") against ONEOK Field Services Company and Lumen Energy Corporation alleging conversion based on their purchase of the storage gas from the producers. In April 2010, the Pratt County State District Court granted the defendants' motion for summary judgment, finding that the Company does not have title to storage gas that has migrated beyond adjoining property. The Company appealed the decision to the Kansas Court of Appeals in April 2010, and the appeal was transferred to the Kansas Supreme Court at the Company's request. Oral argument was held in March 2011. In March 2013, the Kansas Supreme Court determined that the Company lost title to storage gas when it migrated and was produced beyond one mile of the storage field certificated boundaries. The case will be remanded for a determination of the Company's recovery of conversion damages from ONEOK and Lumen for storage gas produced after the June 2010 FERC order.

In December 2011, state court petitions were filed against the Company in three counties in Kansas, alleging trespass, nuisance and unjust enrichment, arising out of the migration of the Company's storage gas. The cases were moved to federal district court in Wichita, Kansas on December 27, 2011, at the request of the Company. The actions had been stayed pending the outcome of the Kansas Supreme Court appeal discussed above. The case will likely remain stayed pending the outcome of the District Court action against the producers.

The Company has recorded Cunningham storage gas losses of 13.7 Bcf from 2004 through 2011. In 2011, the wells were shut-in. The replacement cost of storage gas losses is \$- million and \$6.0 million for the years ended December 31, 2012 and 2011, respectively, which are included in operating and maintenance and cost of gas and liquids sales on the Statements of Income.

While it is not possible to predict with certainty the outcome of the aforementioned litigation and other contingencies, the Company believes that the ultimate resolution of these matters will not have a material adverse effect on the Company's financial results.

Purchase Obligations

The Company expects to incur significant future capital expenditures to meet increased customer growth and system reliability objectives. Capital expenditure needs are reviewed regularly by management and may change significantly as a result of such reviews. Estimates may change significantly at any time as a result of, among other factors, changes in rules and regulations, including environmental; changes in income tax laws; general business conditions; load projections; system reliability standards; the cost and efficiency of construction labor, equipment, and materials; and the cost and availability of capital. Additionally, the Company has commitments to two of its largest customers to meet minimum levels of incremental capacity requests through 2022 and 2026.

Operating Leases, Easements and Maintenance Contracts

The Company has non-cancelable operating leases primarily for office space and rights-of-way. The minimum payments under these leases as of December 31, 2012 were \$2.0 million, \$1.7 million, \$1.4 million, \$1.4 million and \$1.3 million for the years 2013 through 2017, respectively, and \$5.1 million for the total of the years thereafter. These amounts are not reflected on the Balance Sheets. Rent expense on non-cancelable operating leases totaled \$4.3 million and \$4.1 million for the years ended December 31, 2012 and 2011, respectively, and was included in operating and maintenance on the Statements of Income.

(12) Credit Risk

The Company has a concentration of customers in the electric and gas utility industries, principally in the upper Midwestern states. This concentration of customers may impact the Company's overall exposure to credit risk in that the customer base may be similarly affected by changes in economic, industry, weather or other conditions. The Company's ten largest customers accounted for 66% of its system-wide transportation and storage revenue.

The following customers accounted for 10% or more of the Company's total revenues for the years ended December 31 and trade receivables as of December 31:

	Revenue		Accounts Receivable	
	2012	2011	2012	2011
Xcel Energy, Inc. ⁽¹⁾	15%	15%	13%	13%
CenterPoint Energy Resources Corporation ⁽²⁾	12	12	16	15
MEC	10	11	11	11

(1) The Company's agreements are with Northern States Power-Minnesota, Northern States Power-Wisconsin, Northern States Power-Generation and Southwestern Public Service Company, subsidiaries of Xcel Energy, Inc.

(2) The Company's agreements are with CenterPoint Energy Minnesota Gas, CenterPoint Energy Services and CenterPoint Energy Gas Transmission, subsidiaries of CenterPoint Energy Resources Corporation.

For shippers that have withdrawn gas prior to injection under the Company's deferred delivery services, the Company is exposed to credit risk with respect to those counterparties based upon the value of the gas withdrawn. The balances in transportation and exchange gas receivables were \$6.4 million and \$8.9 million as of December 31, 2012 and 2011, respectively. Included in these amounts were balances owed from one customer of \$2.8 million and \$4.4 million as of December 31, 2012 and 2011, respectively, which were related to the Company's deferred delivery services.

As a general policy, collateral is not required for receivables from creditworthy customers. Customers' financial condition and creditworthiness are regularly evaluated, and historical losses have been minimal. In order to provide protection against credit risk, and as permitted by the terms of the Company's tariff, the Company has, among other alternatives, required customers that lack creditworthiness as defined by the tariff to provide letters of credit, cash security deposits or to establish separate legally restricted escrow funds to be held until these customers' creditworthiness can be demonstrated. As of December 31, 2012 and 2011, the Company has reflected on the Balance Sheets escrow funds of \$2.2 million and \$2.1 million, respectively, in other current assets and \$13.5 million and \$13.4 million, respectively, in other assets with offsetting amounts in other current liabilities and other long-term liabilities, respectively.

(13) Other Related Party Transactions

The Company provided gas transportation, storage and other services to MEC totaling \$58.7 million and \$58.6 million for the years ended December 31, 2012 and 2011, respectively. MEC provides certain administrative and management services, including executive, financial, legal, human resources, payroll and tax, to the Company. Expenses incurred by MEC and billed to the Company are based on the individual services and expense items provided and were \$6.9 million and \$6.6 million for the years ended December 31, 2012 and 2011, respectively. MEC also provided electricity and other services to the Company of \$0.5 million for each of the years ended December 31, 2012 and 2011. The Company reimbursed MEC \$58.5 million and \$57.9 million for the years ended December 31, 2012 and 2011, respectively, for payroll, healthcare benefits and other benefit payments that MEC processed on behalf of the Company.

MEHC provides certain administrative and management services, including executive, financial, legal and tax, to the Company. Expenses incurred by MEHC and billed to the Company are based on the individual services and expense items provided and were \$3.1 million and \$4.4 million for the years ended December 31, 2012 and 2011, respectively. Income tax transactions with MEHC resulted in net receipts of \$4.5 million and \$21.2 million for the years ended December 31, 2012 and 2011, respectively.

As of December 31, 2012 and 2011, the Company had net accounts payable to MEHC and certain subsidiaries for intercompany transactions totaling \$0.5 million and \$2.6 million, respectively.

The Company provides certain administrative and management services, including executive, financial, commercial, regulatory and legal, to Kern River Gas Transmission Company ("Kern River"), an indirect wholly owned subsidiary of

MEHC. The Company billed Kern River \$1.1 million for each of the years ended December 31, 2012 and 2011, for these services.

The Company provides risk management services to Kern River, pursuant to a service agreement dated August 1, 2008. The Company relinquishes all risks, liabilities, losses and profits associated with these risk management services. For the years ended December 31, 2012 and 2011, the Company entered into insignificant risk management transactions that settled on behalf of Kern River.

BNSF Railway Company, an affiliate of the Company, provided contributions in aid of construction totaling \$3.9 million and \$- million for the years ended December 31, 2012 and 2011, respectively.

For the years ended December 31, 2012 and 2011, the Company received demand promissory notes bearing interest at a 30-day LIBOR plus a fixed per annum rate from MEHC in exchange for cash of \$- million and \$80.0 million, respectively. The balance of the demand promissory notes as of December 31, 2012 and 2011 was \$230.0 million. Interest income of \$1.5 million and \$1.4 million was recorded for the years ended December 31, 2012 and 2011, respectively.

(14) Subsequent Event

In January 2013, the Company distributed dividends on common stock of \$80.0 million through its parent company to MEHC.